



# **A POSITIVE AND NORMATIVE ANALYSIS OF LENDER CONTROL IN REORGANIZATIONS AND ITS LIABILITY IMPLICATIONS**

by Sergio A Muro

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# **A POSITIVE AND NORMATIVE ANALYSIS OF LENDER CONTROL IN REORGANIZATIONS AND ITS LIABILITY IMPLICATIONS**

A Dissertation

Presented to the Faculty of the Graduate School

of Cornell University

In Partial Fulfillment of the Requirements for the Degree of

Doctor of the Science of Law

by

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August 2010

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# **A POSITIVE AND NORMATIVE ANALYSIS OF LENDER CONTROL IN REORGANIZATIONS AND ITS LIABILITY IMPLICATIONS**

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Cornell University 2010

Lenders have taken over reorganizations. This fact, largely accepted and celebrated by legal and finance scholars, is defended using the framework of the explicit nexus of contracts theory of the firm. This dissertation begins by arguing against the *nonexistent costs* of lender control of reorganization, claiming that the explicit nexus of contracts uses unrealistic assumptions which serve to hide some of the costs of lender control. Specifically, this dissertation shows that lender control costs can arise even in the extreme scenario of having only one class of legal claimants. In addition, this dissertation uncovers that lender control may constrain debtor's investment opportunity set, leading to preclude adaptation possibilities.

This dissertation further shows that lender control liability theories have been largely abandoned by United States courts due to an implicit understanding of the firm within the framework of the explicit nexus of contracts theory. As a result, lender control liability currently is a non-deterrent to opportunistic behavior by controlling creditors, as it merely mimics the absolute priority rule. Additionally, this dissertation shows that fraudulent conveyance law is a poor substitute for lender control liability due to the former's transaction by transaction focus.

Cognitive errors may produce systematic distortions on lender control liability adjudications. This dissertation shows that if hindsight bias was the only cognitive

error affecting adjudications those worries would be unsupported as a strict liability rule would take care of them. Unfortunately, hindsight bias and anchoring working together distort adjudications, making the strict liability rule solution ineffective. Additionally, this dissertation shows that arguments in favor of a no-liability rule for breach of fiduciary duties, à la BJR, do not translate into the lender control liability realm as: a) a no-liability rule wouldn't improve the controlling lender's risk aversion; and b) other opportunistic behavior constraints supportive of the BJR seem empirically irrelevant in lender control liability cases.

Finally, this dissertation proposes to limit opportunistic behavior by controlling lenders. With that aim, it suggests dropping the negative control safe harbor from Agency Law in lender control liability cases within the reorganization context.

## BIOGRAPHICAL SKETCH

Sergio Ariel Muro received his LLB from the Universidad Nacional de Rosario, an MA in Law & Economics from the Universidad Torcuato Di Tella (Buenos Aires), thesis with honors, and an LLM from Cornell University, thesis with honors. He is currently a visiting professor at Universidad Torcuato Di Tella, where he teaches Bankruptcy Theory and Economic Analysis of Corporate Law and at the International University College of Turin, Italy, where he teaches Issues of Law and Finance in Latin America. While at Cornell, he was a teaching assistant in Economic Analysis of the Law during the Fall semester of 2007 and a research assistant on Bankruptcy Law from 2005 to 2007. Before that, he was a research assistant at the University of Texas at Austin in 2004 on International Bankruptcy Law issues. Born and raised in Argentina, Mr. Muro has published articles internationally in Spain, The Netherlands, Mexico and the US.

Sergio Muro is married to Patty and together they have a dog, Rosie, and two cats, Owen and Sammy.

To my family, and especially to Patty, whose unconditional support gave me the strength to finish this dissertation.

## ACKNOWLEDGMENTS

This dissertation gained immensely from generous and illuminating conversations with Theodore Eisenberg, Robert Hockett, Michael Heise, Erica Gorga, Charles Whitehead, Leticia Barrera, Sergio Latorre, BuhmSuk Beck, Slavisa Tasic, Albert Azagra Malo, W. Calvin Ho and Elisa Vecchione. Extremely helpful were comments made by seminar participants at the 2008 Canadian Law and Economics Association Annual Meeting, as well as comments by participants at a 2008 Torcuato Di Tella University seminar, at the Fourth Cornell Inter-University Graduate Student Conference and at a 2007 Real Colegio Complutense seminar in Cambridge, Massachusetts.

I owe special gratitude to Assistant Dean Charles Cramton for his continuous and generous support and help, especially while I was abroad, to Professor Barcelo for his help in designing my dissertation committee and to Professors Lasser and Baistrocchi for their guidance and support during my job search.



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# Bankruptcy Control and the Theory of the Firm

## I. Introduction

Over the last eight years, the idea that bankruptcy practice has trounced the scheme of the 1978 Bankruptcy Code (from now on “The Code”) has emerged. Pioneered by professors Baird and Rasmussen,<sup>1</sup> a cluster of legal literature has developed around the changes in bankruptcy practice, the reasons behind those changes and possible efficiency implications of the professed novel occurrences.<sup>2</sup> There are conflicting opinions over almost every aspect of the debate, but everyone seems to agree that contemporary bankruptcy practice has evolved and looks quite different from the depictions commonly made two decades ago.

Technological changes together with financial innovations<sup>3</sup> seem to have triggered the new developments.<sup>4</sup> Financial contract design has adopted a widespread

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<sup>1</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751 (2002) (from now on TEB)

<sup>2</sup> See Lynn M. LoPucki “The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen’s The End of Bankruptcy”, 56 Stan. L. Rev. 645 (2003); Douglas G. Baird & Robert K. Rasmussen “Chapter 11 at Twilight”, 56 Stan. L. Rev. 673 (2003); David A. Skeel, Jr. “Creditors’ Ball: The “New” New Corporate Governance in Chapter 11”, 152 U. Pa. L. Rev. 917 (2003); David A. Skeel, Jr. “The Past, Present and Future of Debtor-in-Possession Financing”, 25 Cardozo L. Rev. 1905 (2004); Stephen Lubben “The “New and Improved” Chapter 11”, 93 Kentucky Law Journal 839 (2004); Barry E. Adler “Bankruptcy Primitives”, 12 Am. Bankr. Inst. L. Rev. 219 (2004); Jay L. Westbrook “Bankruptcy Control of the Recovery Process”, 12 Am. Bankr. Inst. L. Rev. 245 (2004); Harvey R. Miller & Shai Y. Waisman “Is Chapter 11 Bankrupt?”, 47 B. C. L. Rev. 129 (2005); Douglas G. Baird & Robert K. Rasmussen “Private Debt and the Missing Lever of Corporate Governance”, 154 U. Pa. L. Rev. 1209 (2006); Kenneth M. Ayotte & Edward R. Morrison “Creditor Control and Conflict in Chapter 11”, 1 The Journal of Legal Analysis 511 (2009); Douglas G. Baird & Robert K. Rasmussen “The Prime Directive”, 75 U. Cin. L. Rev. 921 (2007); Adam Feibelman “Commercial Lending and the Separation of Banking and Commerce”, 75 U. Cin. L. Rev. 943 (2007).

<sup>3</sup> Rajan and Zingales refer to them as “a bona fide financial revolution”, where major technological, regulatory and institutional changes are the cause of the new era. See Raghuram G. Rajan & Luigi Zingales “The influence of the Financial Revolution on the Nature of Firms”, 91 American Economic Review 206, 206 (2001)

<sup>4</sup> See Douglas G. Baird & Robert K. Rasmussen “Private Debt and the Missing Lever of Corporate Governance”, 154 U. Pa. L. Rev. 1209, 1228-9 (2006), for a reference to how modern business practices and technology affect control. Professor Skeel, Jr. considers that part of the change is

use of agreement specific, increasingly detailed covenants, which allows creating contracts that depend upon the new monitoring technology.<sup>5</sup> The financial strategist is currently able to employ security interests in virtually all the debtor's property, present and future,<sup>6</sup> which is intertwined with the credit agreement in order to reinforce the power of the lender. These innovations have helped to create new scenarios for lenders, who under the new conditions have a tighter grip on the monitoring of the debtor's financial health. As a result of the increased efficiency of the financial contracting system, lenders' willingness to advance funding appears to have grown, as evidenced by the fewer unencumbered assets that debtors have when entering bankruptcy.<sup>7</sup> Debtors in a compromised financial situation seem eager to accept the new flow of capital.

A related development specific to bankruptcy, debtor-in-possession (from now on "DIP") financing, appears to have fitted perfectly with the eagerness of both

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endogenous to the characteristics of American businesses entering bankruptcy. See David A. Skeel, Jr. "Creditors' Ball: The "New" New Corporate Governance in Chapter 11", 152 U. Pa. L. Rev. 917, 922 (2003)

<sup>5</sup> Monitoring technology can be a cause for incomplete contracts. See, for example, Rohan Pitchford "How Liable Should a Lender Be? The Case of Judgment-Proof Firms and Environmental Risk", 85 American Economic Review 1171, 1174 (1995).

<sup>6</sup> Professors Baird and Rasmussen consider that distressed lending's relative use and importance grew over the last couple of decades helped by the enactment of Article 9 of the UCC and its reform version. "Before Article 9 of the Uniform Commercial Code was enacted, acquiring a security interest in all of a company's property was hard. Each type of collateral had its own legal regime. Moreover, courts viewed with suspicion omnibus clauses that picked up all of the debtor's property and provided no cushion for other creditors. In many instances, secured lending was premised upon the creditor's ability to take possession of discrete assets and sell them in the event that the debtor defaulted. It was not possible to make a secured loan premised upon the corporation's value as a going concern. Article 9, and especially the revised Article 9, have made it possible for lenders to acquire all of a corporation's assets. The modern security interest effectively covers not only a corporation's discrete assets, but also the synergy that each asset has with the others. The expanded security interest not only changes the basis on which the lender extends credit, but also the control that the creditor can exercise over the business." Douglas G. Baird & Robert K. Rasmussen "Private Debt and the Missing Lever of Corporate Governance", 154 U. Pa. L. Rev. 1209, 1228 (2006). The point that security interests over all the assets covers any synergy those assets may have is previously made by Rizwaan Mokhal referring to the British receivership system. See Rizwaan J. Mokhal "The Floating Charge – An Elegy", in Commercial Law and Commercial Practice, pp. 485-93, Sarah Worthington ed. (2003).

<sup>7</sup> See David A. Skeel, Jr. "Creditors' Ball: The "New" New Corporate Governance in Chapter 11", 152 U. Pa. L. Rev. 917, 925 (2003).

lenders and borrowers for more financing.<sup>8</sup> Despite the fact that DIP financing has been allowed for over a century,<sup>9</sup> the new credit market has facilitated the utilization of this tool and has made it prevalent among distressed corporate debtors.<sup>10</sup> DIP financing's pervasive use by chapter 11 corporations shook the foundations of The Code's system, allowing a DIP lender to obtain effective control of the bankrupt debtor.<sup>11</sup>

Originally, The Code's scheme considered the reorganization proceeding as a place where the debtor required some "breathing space"<sup>12</sup> and therefore established an automatic stay<sup>13</sup> on creditors' claims -originated before the debtor entered bankruptcy protection upon filing. The intended effect of the stay was to allow some time for the

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<sup>8</sup> Chatterjee et. al. (2004) document a growth in debtor in possession financing. See Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramirez "Debtor-in-Possession Financing", 28 Journal of Banking & Finance 3097 (2004).

<sup>9</sup> Professor Skeel, Jr. provides a great historical account of the use of receiver certificates as the precursors of DIP financing. See David A. Skeel, Jr. "The Past, Present and Future of Debtor-in-Possession Financing", 25 Cardozo L. Rev. 1905, 1908-16 (2004).

<sup>10</sup> See Maria Carapeto "Does Debtor-in-Possession Financing Add Value?", Cass Business School working paper (2003) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=161428](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=161428). It is not clear exactly when the new system emerged, but it can be safely claimed that it emerged after 1989, where court opinions were not as deferent to DIP financing agreements. See, for example, *In re Tenney Village Co., Inc.*, 104 B.R. 562, 568 (Bankr. D. N.H. 1989) ("Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons usable against it for the bankruptcy estate's benefit, place the Debtor in bondage working for the Bank, seize control of the reins of the organization, and steal a march on other creditors in numerous ways. The Financing Agreement would pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit of the Bank and the Debtor's principals who guaranteed its debt. It runs roughshod over numerous sections of the Bankruptcy Code."); also, see *In re Ames Dept. Stores, Inc.*, 115 B.R. 34, (Bankr. S.D. N.Y. 1990).

<sup>11</sup> See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 Stan. L. Rev. 751, 777-85 (2002).

<sup>12</sup> "The purpose of a business reorganization case ... is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets". H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179

<sup>13</sup> See Bankruptcy Code, 11 U.S.C. § 361 (2000)

debtor firm to negotiate a restructuring with its creditors. Implicit in this idea was the fact that a distressed debtor was unlikely to obtain credit upon entering bankruptcy protection. Therefore, the debtor would use as financing the cash- flow that otherwise he would have used to pay creditors during the length of the reorganization proceeding. Pre-petition creditors were required to act as (involuntary) financiers for the turnaround on the promise that their recovery would be larger due to the forced financing. As a result, creditors shouldered the cost of being forced financiers while at the same time suffered from the smaller leverage they could exercise over a debtor in distress due to the lack of repossession threat.

Nonetheless, The Code limited DIP's use and disposition of assets upon the existence of security interests.<sup>14</sup> As debtors entered bankruptcy with a larger percentage of assets encumbered, the obsolescence of The Code financing system has become apparent.<sup>15</sup> Post-petition financing has taken a prominent role. Creditors have been lured to provide fresh funding to the DIP by the advantages available in section 364.<sup>16</sup> As the court in *In Re Glover, Inc.* expressed it, without the advantages of section 364, obtaining credit could be an insurmountable task:

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<sup>14</sup> See Bankruptcy Code, 11 U.S.C. § 363 (2000)

<sup>15</sup> Professor Skeel, Jr. also attributes the demise of the code financing system to the fact that "the value of New Economy assets deteriorates quickly..." See David A. Skeel, Jr. "The Past, Present and Future of Debtor-in-Possession Financing", 25 Cardozo L. Rev. 1905, 1920 (2004). See David A. Skeel, Jr. "Creditors' Ball: The "New" New Corporate Governance in Chapter 11", 152 U. Pa. L. Rev. 917, 918-9 (2003) ("the "new" new Chapter 11 governance is contractual in nature... Before they even file for bankruptcy, corporate debtors must arrange an infusion of cash to finance their operations in Chapter 11. To an increasing extent, lenders are using these loan contracts to influence corporate governance in bankruptcy. The fate of an asset or division of the company, even the terms of a transfer of control, has been spelled out as terms in a debtor's DIP financing agreement."). Brecht, Bolton & Roel consider that "the term "corporate governance" derives from an analogy between the government of cities, nations or states and the governance of corporations." See Marco Brecht, Patrick Bolton & Alisa Roell "Corporate Governance and Control", working paper available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=343461](http://papers.ssm.com/sol3/papers.cfm?abstract_id=343461) (last visited 7/15/07).

<sup>16</sup> Section 364 of the Bankruptcy code allows the DIP to contract credit with the possibility of providing security interests in both unencumbered and encumbered assets (the later with priority over any previous liens). See 11 U.S.C. §364 (2000).

“Creditors are often loathe to knowingly extend credit to entities in reorganization. Apart from the onus of bankruptcy, payments may be deferred months or years even if the reorganization is a complete success.”<sup>17</sup>

These post-petition credit arrangements have allowed the post-petition lender to gain leverage over the debtor: because these lending agreements are made after the filing for bankruptcy, this lender isn’t constrained by the automatic stay provision of The Code. As a consequence, and based on the perceived need to attract fresh capital to the firm, those DIP financing agreements can be readily enforced upon default.<sup>18</sup> As the number of events of default accepted by courts in their DIP financing decisions has grown, so has the amount of influence exerted by the lender. For example, it is fairly common for lenders to bargain for a “forced sale” deadline, meaning that if the debtor doesn’t sell the assets or obtain approval of a reorganization plan by a certain pre-specified date, then an event of default occurs.<sup>19</sup>

This new “contractual” face of corporate bankruptcy has been received with praise,<sup>20</sup> as well as doubt.<sup>21</sup> TEB considers that

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<sup>17</sup> See *In re Glover, Inc.*, 43 B.R. 322, 324 (*Bkrcy.N.M.*, 1984)

<sup>18</sup> This result is due to the fact that section 362(a) of the code stays only action originated before the commencement of the proceedings. See 11 U.S.C. §362(a). Additionally, lenders usually bargain for a covenant in the DIP financing agreement expressing the debtor’s “consent to automatic relief from the stay upon the occurrence of an event of default under the post-petition lending agreement.” See 5 Norton Bankr. L. & Prac. 3d §94:33.

<sup>19</sup> See 5 Norton Bankr. L. & Prac. 3d §94:33.

<sup>20</sup> See Douglas G. Baird & Robert K. Rasmussen “Private Debt and the Missing Lever of Corporate Governance”, 154 U. Pa. L. Rev. 1209 (2006); David A. Skeel, Jr. “The Past, Present and Future of Debtor-in-Possession Financing”, 25 Cardozo L. Rev. 1905, 1920-1 (2004). The idea of control transfers due to debt covenant violations is widely accepted in the finance literature. See, for example, Sudheer Chava & Michael R. Roberts “How Does Financing Impact Investment? The Role of Debt Covenants”, 63 Journal of Finance 2085, 2085 (2008) (“Upon breaching a covenant, control rights shift to the creditor who can use the threat of accelerating the loan to choose their most preferred course of action or to extract concessions from the borrower to choose the borrower’s most preferred course of action”)

<sup>21</sup> See Jay L. Westbrook “The Control of Wealth in Bankruptcy”, 82 Tex. L. Rev. 795 (2004); See



“Today’s investors allocate control rights among themselves through elaborate and sophisticated contracts that already anticipate financial distress. In the presence of these contracts, a law of corporate reorganizations is largely unnecessary.”<sup>22</sup>

TEB assures us that a senior lender is more likely to make sound decisions than a debtor. Professor Skeel, Jr. quickly joins the normative idea adding that the new “governance levers have dramatically improved the quality of chapter 11 governance.”<sup>23</sup>

The recognition of the new state of bankruptcy affairs has presented several questions to the academic debate. There are important issues that require further examination to understand what the role played by creditors in the new setting is. Two essential issues to investigate are the scope and concentration of bankruptcy control and, if indeed we can assume that there is a transfer of control to the DIP lender, whether creditor control generates uninvestigated costs that we should take into account when evaluating its efficiency, which will be the focus of the present work.

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Stephen Lubben “The “New and Improved” Chapter 11”, 93 Kentucky Law Journal 839 (2004).

<sup>22</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 755 (2002). In the same vein they mention “When control rights are allocated coherently, no legal intervention is needed to ensure that decisions about the firm’s future are made sensibly. Most large firms now allocate control rights among investors in a way that ensures coherent decisionmaking throughout the firm’s life cycle.” See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 778 (2002). This view seems confirmed in the case of failed high tech start-ups where Mann found that bankruptcy is an unusual tool compared to privately arranged assignment for the benefit of creditors. See R. Mann “An Empirical Investigation of Liquidation Choices Failed High Tech Firms”, 82 Wash. U. L. Q. 1375 (2004). Interestingly, Baird writing with Jackson several years before was much more skeptical about a creditor laden procedure. See Douglas G. Baird & Thomas H. Jackson “Fraudulent Conveyance and its Proper Domain”, 38 Vand. L. Rev. 829, 836 (1985) (“Complete deference to creditor protection in fashioning legal rules makes no more sense than complete deference to debtor freedom. Any device that protects creditors inevitably brings costs as well as benefits.”)

<sup>23</sup> See David A. Skeel, Jr. “Creditors’ Ball: The “New” New Corporate Governance in Chapter 11”, 152 U. Pa. L. Rev. 917, 920 (2003)

Control has been used in many different ways in different disciplines. Even within the same discipline, many authors define or simply refer to control in distinct ways. An examination of the conceptual borders of control may help distinguish different perceptions of control and understand their diverse implications.<sup>24</sup> In order to inform the scrutiny of control this chapter will delve into the different theories of the firm as an inevitable base for the understanding of control.

This chapter will proceed as follows: Part II will describe in greater detail chapter 11 original governance structure and the way in which it is modified by lender control. Then, I will discuss TEB view of the theory of the firm as a theoretical building tool. I will argue that TEB's view is rather superficial and therefore a deeper study of the theory of the firm is required in order to better assess the efficiency of lender control. Part III will look into different conceptualizations of the theories of the firm and derive from it the notion of value and control under each theory. That will lead to the study of potential externalities arising out of different control definitions. Part IV will utilize the framework established in part III to evaluate specifically the effects of lender control. I will argue that lender control generates costs independent of those arising out of any conflict of interest between claimholders. Finally, Part V will provide a few concluding remarks.

## **II. Reorganization governance and TEB's idea of the firm**

### **A. Understanding chapter 11 governance**

The degree of difficulty that defining control entails does not appear to adequately correspond with the profuse use the concept has in many completely

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<sup>24</sup> Professor Skeel, Jr. provides two examples of control that differ in scope, with the US Air case involving the financier dictating the course of the reorganization case and the TWA case implying a lesser degree of control. See David A. Skeel, Jr. "The Past, Present and Future of Debtor-in-Possession Financing", 25 Cardozo L. Rev. 1905, 1920-1 (2004).

different fields.<sup>25</sup> Much of the difficulty around the concept of control starts with the diverse, and often inconsistent, meanings that are attributed to it.<sup>26</sup> Control is used in a variety of contexts to express proficiency, limitation or restraint, prevention of the spread of, regulation, verification, influence, etc. Indeed, Oliga mentions that “In social science literature, the concept of control is as elusive as it is pervasive.”<sup>27</sup>

Perhaps due to the difficulties that defining control entails, the corporate governance literature usually discusses control by focusing on the possibility of winning battles in shareholder meetings. This conceptualization, which follows the ideas presented by Professor Manne<sup>28</sup> and before him Professors Berle, jr. and Means, heavily depends on the formal structure of business associations’ which have the shareholders (or equity holders in general) as the ultimate decision making body. As a large proportion of public companies have dispersed ownership in the United States, a gap has arisen between the formal idea behind business associations’ formal structure

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<sup>25</sup> The profuse use of a vague concept may not be a problem at all for the philosophy of language if it was aimed at “Finding and analyzing borderline cases and refining theories and definitions...” See Bjorn Hofmann “The Concept of Disease – Vague, Complex, or just indefinable?”, *Medicine, Health Care and Philosophy*, Online First, available at <http://www.springerlink.com.proxy.library.cornell.edu/content/k0j6824323582v08/fulltext.pdf>

<sup>26</sup> Control seems to be at times a vague concept while at others an ambiguous or even an indefinable one (i.e. because it is ever- changing or because it is a primitive element of natural language, akin to a semantic prime).

<sup>27</sup> See John C. Oliga, *POWER, IDEOLOGY AND CONTROL*, Plenum Press, New York, NY (1996), at 139. The difficulty in defining control is shared with other concepts, as for example the concept of disease. See Per Sundstrom “Disease: The phenomenological and conceptual center of practical-clinical medicine”, In *Handbook of phenomenology and medicine*, ed. S. Toombs, 109-26, Dordrecht: Kluwer Academic Publishers, at 110 (“The meaning of the word ‘disease’ is vague, elusive, and unstable. You may reach for it, but you won’t grasp it, except in pieces and fragments. It is prone to changes, permutations, and shatterings – according to the circumstances, or irrespective of them. And yet, you can use the word, and you may feel confident that it carries some meaning – at least most of the time”), cited by Bjorn Hofmann “The Concept of Disease – Vague, Complex, or just indefinable?”, *Medicine, Health Care and Philosophy*, Online First, available at <http://www.springerlink.com.proxy.library.cornell.edu/content/k0j6824323582v08/fulltext.pdf>

<sup>28</sup> See Henry G. Manne “Mergers and the Market for Corporate Control”, 73 *The Journal of Political Economy* 110 (1965). Unfortunately, Professor Manne didn’t define control, and focus on the market for such control.

and practical decision- making.<sup>29</sup> As a result of that divide, control has been portrayed since Berle, jr. and Means as potentially separate from ownership.<sup>30</sup>

Several years after the work of Berle and Means, Professor Manne re-tied the idea of ownership and control. Manne argued that corporate control constitutes a valuable asset, independent of any economies of scale or scope.<sup>31</sup> Manne's considered that there are three main ways to obtain control of a corporation: a proxy fight, direct purchase of shares (as in the case of a takeover) and mergers.<sup>32</sup> Despite the indeterminacy of the concept of control under Manne's view, control is clearly tied to the voting rights of shares and has then to derive from the formal corporate law structure.<sup>33</sup> The ability to win elections at shareholder meetings and, specifically, to appoint directors to the board are the core or ultimate means of exercising control, because "the powers of the board of directors are plenary."<sup>34</sup>

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<sup>29</sup> The work of Berle, jr. and Means focused on control while investigating the degree of concentration of stock holdings in large corporations. See Adolf A. Berle, jr. & Gardiner C. Means "The Modern Corporation and Private Control", The Macmillan Company, New York, New York (1933). Whenever concentration levels are higher, then discussions center in different issues. See, for example, Marco Brecht, Patrick Bolton & Alisa Roell "Corporate Governance and Control", working paper available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=343461](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343461) (last visited 7/15/07).

<sup>30</sup> For example, see Alfred D. Chandler, Jr. "Scale and Scope. The Dynamics of Industrial Capitalism", The Belknap Press of Harvard University Press, Cambridge, MA (1990), at 85.

<sup>31</sup> See Henry G. Manne "Mergers and the Market for Corporate Control", 73 The Journal of Political Economy 110, 112 (1965). Professor Manne followed in this regard Professors Berle, jr and Means. See Adolf A. Berle, jr. & Gardiner C. Means "The Modern Corporation and Private Control", The Macmillan Company, New York, New York (1933), p. 69.

<sup>32</sup> See Henry G. Manne "Mergers and the Market for Corporate Control", 73 The Journal of Political Economy 110, 114-9 (1965). Professors Berle, jr. and Means expressed "Since direction over the activities of a corporation is exercised through the board of directors, we may say for practical purposes that control lies in the hands of the individual or group who have the actual power to select the board of directors, (or its majority), either by mobilizing the legal right to choose them—"controlling" a majority of the votes directly or through some legal device- or by exerting pressure which influences their choice." See Adolf A. Berle, jr. & Gardiner C. Means "The Modern Corporation and Private Control", The Macmillan Company, New York, New York (1933), p. 69.

<sup>33</sup> The view of the relative importance of voting as a governance mechanism is shared by Easterbrook and Fischel who consider that "The right to vote is the right to make all the decisions not otherwise provided by contract – whether the contract is express or supplied by legal rules." See Frank H. Easterbrook & Daniel R. Fischel "Voting in Corporate Law", 26 Journal of Law and Economics 395, 402 (1983).

<sup>34</sup> See Douglas G. Baird & Robert K. Rasmussen "The Prime Directive", 75 U. Cin. L. Rev. 921, 924 (2007). Due to the broad scope of its powers, they refer to the board of directors as "the locus of

Following the extant work of Manne, corporate governance scholarship has devoted a great deal of attention to investigate the factors influencing boards' composition, action and inaction,<sup>35</sup> while aiming at better understanding organizational survival.<sup>36</sup> There is a great degree of uncertainty surrounding actual allegiances, if any, of firm executives to the board. This uncertainty is not dissipated in the bankruptcy context and possibly it is enlarged.<sup>37</sup> Maybe because of the somewhat unobservable nature of board of directors' decision-making process and the belief that boards are susceptible to be captured,<sup>38</sup> attention has partially shifted to other actors in the quest for governance clues. In the case of bankruptcy, an individual or group of

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corporate governance." See Douglas G. Baird & Robert K. Rasmussen "The Prime Directive", 75 U. Cin. L. Rev. 921, 923 (2007). Talking about high shareholder concentration, Brecht, Bolton & Roell consider that "Most of the time large shareholder action is channelled through the board of directors. Large shareholders are in principle able to appoint board members representing their interests. When they have majority control of the board they can hire (or fire) management. Large shareholders can also exercise power by blocking ratification of unfavourable decisions, or possibly by initiating decisions."

<sup>35</sup> See, for example, Eugene Fama "Agency Problems and the Theory of the Firm", 88 Journal of Political Economy 288 (1980) (arguing for the efficiency of independent directors where share ownership is dispersed); Benjamin E. Hermalin & Michael S. Weisbach "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature", 9 Economic Policy Review 7 (2003) (discussing the effects of board independence); Lucian A. Bebchuk "The Case for increasing Shareholder Power", 118 Harv. L. Rev. 833 (2005) (looking at ways in which management captures the board); William J. Donohue "To File or Not to File? Systemic Incentives, Corporate Control, and the Bankruptcy Decision", 30 Journal of Management 239 (2004) (studying the incidence of board composition on the financial condition of the firm when filing); Randall S. Kroszner & Philip E. Strahan "Bankers on Boards: Monitoring, Conflict of Interests, and Lender Liability", 62 Journal of Financial Economics 415 (2001) (studying volatility effects of bank representatives on the board of director if their client); Vidhi Chhaorchharia & Yaniv Grinstein "Corporate Governance and Firm Value: The Impact of the 2002 Governance Rules", 62 Journal of Finance 1789 (2007) (studying the incidence of board independence of firm performance).

<sup>36</sup> As Fama and Jensen describe it "Organizational survival involves a balance of the costs of alternative decision systems and systems for allocating residual risk against the benefits." See Eugene F. Fama & Michel C. Jensen "Separation of Ownership and Control", 26 Journal of Law and Economics 301, 307 (1983).

<sup>37</sup> See for example Douglas G. Baird & Robert K. Rasmussen "The Prime Directive", 75 U. Cin. L. Rev. 921, (2007), where they discuss the possibility of executives "capturing" the board of directors.

<sup>38</sup> See Melvin A. Eisenberg, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS*, Beard Books, 139-148 (1976). The term capture refers to a difference between what one party expends and what the other party gets in the appropriation of a right. See Yoram Barzel, *ECONOMIC ANALYSIS OF PROPERTY RIGHTS*, Cambridge University Press, 2d ed. 5-6 (1997).

claimholders is the natural candidates to become ‘capturers’ of the board because of the parallelism that exist between them and shareholders of non-bankrupt firms.<sup>39</sup>

Following the formal idea of control advanced by Berle and Means as well as Manne, voting rights assigned to bankruptcy claims by chapter 11 would be theoretically decisive in The Code’s scheme in order to approve a reorganization plan and let the debtor exit bankruptcy.<sup>40</sup> In other words, The Code thought about giving the claimholders as a whole the possibility to negotiate and be outcome determinative. As a result, reorganization control under the Manne ideal has been at least partially extracted from shareholders voting and redirected to claimholder voting, almost entirely creditor voting.<sup>41</sup> This insight has been recognized by some market players who actively have pursued the acquisition of bankruptcy claims in order to achieve control or block reorganization plans, in pursue of extracting additional rents.<sup>42</sup>

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<sup>39</sup> The parallel to the governance focus of Berle, jr and Means on shares voting power as determinants of control is clear. See Adolf A. Berle, jr. & Gardiner C. Means “The Modern Corporation and Private Control”, The Macmillan Company, New York, New York (1933).

<sup>40</sup> Under this view, the corporate governance structure under the Code works as an unusual corporation where dollars of credit function as shares and priority serves as preferred stock.

<sup>41</sup> It is important to note that a reorganizing corporation has a complex control structure, even if control is composed merely of voting power, given that shareholders’ retain a the power to elect directors all through the proceedings. See *In re Bush Terminal Co.*, 78 F.2d 662, 664 (2<sup>nd</sup> Circuit, 1935) (“Obviously, the stockholders should have the right to be adequately represented in the conduct of the debtor’s affairs, especially in such an important matter as the reorganization of the debtor. Such representation can be obtained only by having as directors persons of their choice... No reason is advanced why stockholders, if they feel that the present board of directors is not acting in their interest, or has caused an unsatisfactory plan to be filed on behalf of the debtor, should not cause a new board to be elected which will act in conformance with the stockholders’ wishes.”); *In re Johns-Manville Corporation et al. v. The Equity Security Holders Committee*, 801 F.2d 60, 64 (2<sup>nd</sup> Circuit, 1986) (stating that “the well settled rule that the right to compel a shareholders’ meeting for the purpose of electing a new board subsists during reorganization proceedings” and that the shareholders’ right to govern their corporation is “a prerogative generally uncompromised by reorganization”)

<sup>42</sup> The main strategy was to acquire a blocking number of claims so as to make sure that they have veto power of any reorganization plan. Hence, anybody proposing a plan needed to, at least, negotiate it with this negatively “controlling” creditor. See generally Chaim J. Fortgang & Thomas M. Mayer “Trading Claims and Taking Control of Corporations in Chapter 11”, 12 Cardozo L. Rev. 1 (1990); Robert K. Rasmussen & David A. Skeel, Jr. “The Economic Analysis of Corporate Bankruptcy Law”, 3 Am. Bankr. Inst. L. Rev. 85, 101-2 (1995); Frederick Tung “Confirmation and Claims Trading”, 90 Nw. U. L. Rev. 1684 (1996).

Professors Baird and Rasmussen, followed by Professor Skeel, Jr., have exposed the fact that the above description of the bankruptcy control picture is incomplete and most likely outdated.<sup>43</sup> They have described a world where Manne's view of the "voting power" nature of control is rather unimportant in today's bankruptcy practice. What TEB unveiled is that the commonly perceived duality of firms either reorganizing through the approval of a plan or liquidating with the resulting loss of value (the two formal exit possibilities under The Code), is a false dichotomy. Auctions of the firm or a division of the firm are possible without any need for creditor voting or liquidation through the section of The Code authorizing DIP's sale of assets.<sup>44</sup> According to TEB, firm or division auctions' are possible because the market for distressed firms has continually developed and became more efficient,<sup>45</sup> preventing the big losses associated with selling assets or firms in bankruptcy.<sup>46</sup> The implicit assumption in TEB follows from the classic hypothetical consent idea: neither claimholders nor the bankruptcy judge should object to the auction because the latter is a wealth creating mechanism.<sup>47</sup>

As a result of the development of a larger market for distressed firms, the possibility to achieve control through other means has risen as a lucrative one.<sup>48</sup> If a

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<sup>43</sup> This idea was not entirely new. The literature based on different theories using control to assign liability, subordinate or recharacterize claims already employed the concept of creditor control in distressed situations. See for example Jeremy W. Dickens "Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control"", 65 Tex. L. Rev. 801 (1987).

<sup>44</sup> See 11 U.S.C. §363

<sup>45</sup> See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 Stan. L. Rev. 751, 786-8 (2002); Robert G. Hansen "Auctions of Companies", 39 Econ. Inquiry 30 (2001). Eisenberg has challenged the notion of liquid and efficient market for firms exists, as it is not the same to have efficient market for securities than for firms (large collection of securities). See Theodore Eisenberg "Baseline Problems in Assessing Chapter 11", 43 University of Toronto Law Journal 633 (1993).

<sup>46</sup> These losses are usually referred to as "asset fire sales". See, for example, Gregor Andrade & Steven N. Kaplan "How costly is Financial (not Economic) Distress: Evidence from Highly Leveraged Transactions that Became Distressed", 53 Journal of Finance 1443 (1998).

<sup>47</sup> On the hypothetical consent idea, see Daniel Brudney "Hypothetical Consent and Moral Force", 10 Law and Philosophy 235, 236-40 (1991).

<sup>48</sup> This follows Manne's idea described above that control has a value in itself.

party is able to obtain the reins of the bankrupt firm, she has an exit strategy to the claimholder voting/ liquidation duality. The exit strategy further increases the bargaining power of a controlling party, as the DIP lender could potentially be, which could be reflected in the possibility to demand management termination. In turn, this signals the degree of control that DIP lenders, as controlling parties, can acquire.<sup>49</sup> Theoretically, then, anyone who obtains full control (if such a thing is ever possible) would be in a position to determine the fate of the estate assets without the need for any negotiation with other bankruptcy constituents. The exit strategy generally accentuates the leeway of the DIP and naturally, the importance of the chapter 11 process's governance.<sup>50</sup>

Arguably, the importance of chapter 11 governance takes the system by surprise. The Code's design has left out many corporate governance issues, relying heavily on the non-bankruptcy law applicable to each specific case, either because it thought to keep the consistency of governance rules or because it believed that those items were of an ancillary character.<sup>51</sup> The increased flexibility gained by the DIP as a

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<sup>49</sup> See F.H. Buckley "The Termination Decision", 61 UMKC. L. Rev. 243, 256 (1992) ("While displacement is often a discrete event, it might also amount to a gradual shift of control to creditors. As the firm lurches towards financial distress, the firm must rely more heavily upon major lenders, and its managers will become more susceptible to creditor influence. The firm will seek to provide full information to the lender, whose express restrictive covenants might be bolstered through an informal veto over general investment policies. The loan agreement might also provide for creeping creditor control through rights to nominate an increasing number of directors as financial covenants are breached.")

<sup>50</sup> Following Brecht, Bolton & Roell (2002) "corporate governance is concerned with the resolution of collective action problems among dispersed investors and the resolution of conflict of interests between various corporate claimholders." See Marco Brecht, Patrick Bolton & Alisa Roell "Corporate Governance and Control", working paper available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=343461](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343461) (last visited 7/15/07), p.113 The term evolved from analogy between the government of nations and cities and that of the corporations. See Marco Brecht, Patrick Bolton & Alisa Roell "Corporate Governance and Control", working paper available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=343461](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343461) (last visited 7/15/07), p.6.

<sup>51</sup> Elson, Helms & Moncus consider that "Traditionally, the focus in chapter 11 restructurings has been on financial and managerial reform, largely ignoring equally important issues of corporate governance." See Charles M. Elson, Paul M. Helms & James R. Moncus "Corporate Governance Reform and Reemergence from Bankruptcy: Putting the Structure Back in Restructuring", 55 Vand. L. Rev. 1917, 1918 (2002). A reflection of the lack of importance given by the Code to governance structures in



result of a better market for bankruptcy sales and the appearance of a creditor vying to control the process trumps The Code's assumption that the debtor, absent the appointment of a trustee,<sup>52</sup> would be running the firm through the process that leads to the approval of the reorganization plan.<sup>53</sup> This is the configuration which allows for a lender to obtain what Baird and Rasmussen have called the "missing lever" over a distressed debtor, through his dealings with the debtor,<sup>54</sup> eventually tramping any control exercised through voting by either shareholders or claimholders.<sup>55</sup>

In order for a lender to exercise control and potentially prevent value dilution, the lender must have such exercise as a feasible possibility. To better determine which types of control are feasible for the lender we must first look at the theory of the firm.

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chapter 11 is the lack of explicit sections focalizing on it. Similarly, the Code provides for mandatory formation of unsecured creditors committee without providing any guidance into the regulation and functions it should have. See Daniel J. Bussel "Coalition-Building through Bankruptcy Creditors' Committees", 43 UCLA L. Rev. 1547, 1549 (1996). The situation was different under the 1973 Report of the Commission on the Bankruptcy Laws of the United States, which vowed for the mandatory appointment of trustees if the debtor owed 1 million or more dollars or had 300 or more security holders, the figure of the administrator to handle non-judicial matters or the express focus on control when looking at the differences between former Chapters X, XI and XII of the Bankruptcy Act. See Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93rd Cong., 1st Sess., pp. 244-53 (1973).

<sup>52</sup> See 11 U.S.C. § 1104 (a).

<sup>53</sup> This feature of chapter 11 has been referred to as being biased towards status quo and lacking commitment to protect creditors' rights. See William W. Bratton "Venture capital on the Downside: Preferred Stock and Corporate Control", 100 Mich. L. Rev. 891, 894 (2002).

<sup>54</sup> See in general Douglas G. Baird & Robert K. Rasmussen "Private Debt and the Missing Lever of Corporate Governance", 154 U. Pa. L. Rev. 1209 (2006). It is true that no interested party can determine how the reorganization process unwraps without petitioning to the bankruptcy court for approval of a petition to sell assets - see 11 U.S.C. § 363(b)(1) - or presenting a reorganization plan for court confirmation - see 11 U.S.C. § 1129 -. Nonetheless, due to the governance structure of the firm which allows great leeway to directors in their decision under the business judgment rule, it is easier to exercise influence or control over the process and over the debtor assets, through influencing or controlling the debtor himself, because the chapter 11 structure respected directors' outside of bankruptcy right to govern the bankrupt firm. On the business judgment rule see for example *Aronson v. Lewis*, 473 A.2d 805, 812 (1984) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.")

<sup>55</sup> Indeed, leverage is so important in Professors Baird and Rasmussen's regard that they report that "when a business enters financial distress, the major decisions... require the blessing of the banks." See in general Douglas G. Baird & Robert K. Rasmussen "Private Debt and the Missing Lever of Corporate Governance", 154 U. Pa. L. Rev. 1209, 1212 (2006).

The study of the theory of the firm as an important methodological step to understand reorganizations was also a central feature of TEB's framework. TEB's objective when looking at the theory of the firm was to use it in order to assess the efficiency of firm continuation. I depart from TEB's analytical framework in that I will employ the theory of the firm to understand what the firm is, as necessary step to comprehend its implications for what control can be applied to. Only then, I suggest, can efficiency consequences be assessed. The following section will review TEB's understanding of the theory of the firm.

### **B. Revisiting TEB's view of the theory of the firm**

As we have seen, lending arrangements nowadays, supervised to a certain extent by the courts,<sup>56</sup> are the key device utilized by a creditor in order to gain influence over the DIP and, more generally, the bankruptcy process. The sophistication of those lending contracts in the case of distressed borrowers has grown to the extent that they are commonly reported to be extremely detailed, containing a googol of covenants that the borrower is needed to abide by.<sup>57</sup> Allegedly, if any covenant gets violated the borrower will have to accede to the lender's requests in order to obtain the necessary default waivers and keep the hope of a successful reorganization alive. One of the requests may involve the appointment of a restructuring officer,<sup>58</sup> a board member or even a new manager, presumably either

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<sup>56</sup> Section 364(c) and 364(d) gives the court power to authorize DIP financing after notice and a hearing. See 11U.S.C. §364(c), (d)

<sup>57</sup> A study by Chatterjee, Dhillon and Ramirez has showed that detailed covenants were found in DIP financing cases with a higher frequency than previous literature found in other context (almost 100% of cases). See Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramirez "Debtor-in-Possession Financing", 28 Journal of Banking & Finance 3097, 3108 (2004).

<sup>58</sup> On the capability of restructuring officers, Miller & Waisman contend that "CROs are typically vested with executive decision making power and direct access to the debtor's board, but they can talk to the lenders without reporting back to the board." See Harvey R. Miller & Shai Y. Waisman "Is Chapter 11 Bankrupt?", 47 B. C. L. Rev. 129, 154 (2005).

philosophically or relationally (or both) closer to the lender.<sup>59</sup> As a result, the lender can be ‘naturally’ understood to be running the show, something that TEB believes it is more efficient than The Code’s scheme, especially as TEB believes that firms in financial distress have little if any going concern value.<sup>60</sup>

TEB’s examination insightfully starts with a look at the theory of the firm and proposes that more attention needs to be placed on the relation between the economic and legal understandings of the firm.<sup>61</sup> Unfortunately, TEB rapidly focuses on insolvency applications without first precisely delimiting what the firm is in order to apply it to what lender control means as function of that idea. Nonetheless, TEB provides several leads into what its construction of the theory of the firm may be. TEB maintains that the firm is basically a nexus of contracts.<sup>62</sup> Their view is heavily influenced by Ronald Coase’s understanding of transaction costs,<sup>63</sup> which they claim “now dominates the theory of the firm.”<sup>64</sup> Maybe because their grasp of the theory of the firm is so heavily influenced by transaction costs, which have been reduced by technological developments, TEB contends that the “ability to conduct business

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<sup>59</sup> See Douglas G. Baird & Robert K. Rasmussen “Private Debt and the Missing Lever of Corporate Governance”, 154 U. Pa. L. Rev. 1209, 1233 (2006).

<sup>60</sup> TEB arrives to this conclusion as it believes that intangible assets (i.e. the business model) are the nowadays’ valuable assets and if the firm is in distress they likely have no value. See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 763-8 (2002). TEB’s position is closely related to what Williamson describes as the strong- form natural selection idea rather than the weak- form natural selection. In the later, the *fitter* survive, but there’s no absolute sense with which to assess whether they are the *fittest*. See Oliver E. Williamson “Corporate Finance and Corporate Governance”, 43 Journal of Finance 567, 573 (1988).

<sup>61</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 757-8 (2002). Much of the following analysis on the theory of the firm and the related control concept will focus on TEB, because Creditors’ Ball, nor The Past, the Present and the Future have claims into the definition of either concept.

<sup>62</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 757 (2002).

<sup>63</sup> See Ronald H. Coase “The Nature of the Firm”, 4 *Economica* 386 (1937).

<sup>64</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 757 (2002). Whether a transaction costs approach dominates now the theory of the firm is not at all clear. Indeed, the number of works on the theory of the firm that are not based on transaction costs economics is very large.

through contracts as easily as inside a firm is increasingly common today.”<sup>65</sup> As a result, the set of economic activities to be performed inside firms relative to those to be carried out through markets has been reduced significantly.

Had TEB stopped there and had it left us with the idea that the firm is a nexus of explicit contracts, it would be possible to criticize their view of the firm in general terms, because it treats contracts as complete posing no incentive problems,<sup>66</sup> uses transaction costs as the unit of analysis which is problematic when bureaucratic costs relate to many transactions,<sup>67</sup> and the market is treated as a black box (in the same way that the firm was treated by neoclassical theory).<sup>68</sup> But TEB has looked at firms and has pointed at other sources of value. They mention the existence of firm specific assets (both tangible and intangible),<sup>69</sup> team grounded knowledge or expertise,<sup>70</sup> and, more generally, going concern value.<sup>71</sup>

The recognition of the existence of knowledge in teams which can be carried to other firms,<sup>72</sup> as well as human specific assets, means that it is possible to conceive intangible assets which cannot be fully protected by the law or contract, probably due to the fact that both are incomplete legal devices.<sup>73</sup> As a result, transaction costs may

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<sup>65</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 770 (2002).

<sup>66</sup> See Bengt Holmström & John Roberts “The Boundaries of the Firm Revisited”, 12 Journal of Economic Perspectives 73, 76 (1998).

<sup>67</sup> See Paul R. Milgrom & John Roberts, *ECONOMICS, ORGANIZATION & MANAGEMENT*, Prentice Hall, Englewood Cliffs, N.J. (1992), at 32-3.

<sup>68</sup> See Bengt Holmström & John Roberts “The Boundaries of the Firm Revisited”, 12 Journal of Economic Perspectives 73, 77 (1998).

<sup>69</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 758-68 (2002). Firm specific assets are those which have a larger value inside the firm than outside.

<sup>70</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 768-77 (2002).

<sup>71</sup> See section II.C, *supra*.

<sup>72</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 773-4 (2002).

<sup>73</sup> Due to human inability to plan for some future scenarios and to rationally deciding not to describe others because of the expense involved in planning for them.

not be the only factor to focus our attention on for efficiency purposes. The allocation of resources and power may generate important ex ante as well as ex post incentives. In addition, despite the fact that TEB discusses growth options, the concentration on transaction costs (natural consequence of their view of the theory of the firm) generates a static understanding of the firm. If a firm can buy and sell all its inputs (including contracts) on each period independently of previous ones, then each period has no influence over the following ones. This static perspective limits the possibility to fully grasp the nature of growth opportunities, its interrelation with assets in place and how to keep them inside the firm.<sup>74</sup>

Therefore, it must be concluded that TEB's understanding of the theory of the firm is inconsistent with an explicit nexus of contracts view. Unfortunately, TEB's view cannot be perfectly fitted under other understandings of the theory of the firm either, despite the fact that TEB's definition of control is closely related to the property rights approach

“control is the ability to make decisions regarding the deployment of assets, including human capital”.<sup>75</sup>

As it will become clearer in the next section, TEB's nexus of contracts conception of the firm could never be consistent with a property rights approach because the former is based on contractual completeness while the later is founded on contractual incompleteness.

From this account of TEB's view, we can see that TEB leaves us orphans of a theory of the firm which could be used to explore the consequences of assigning

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<sup>74</sup> See Luigi Zingales “In search for New Foundations”, 55 Journal of Finance 1623, 1635-7 (2000).

<sup>75</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 779 (2002). This definition is very similar to the one provided by Hart and mentioned in section II.B.4, *supra*.

control to a creditor. In particular, defining the firm will determine where value comes from and will influence how to protect and foster that value (which will likely depend on how control is allocated). The following section will then explore different theories of the firm and the way they determine where value comes from and the sets of feasible control which can be exercised.

### **III. Theories of the firm**

The preceding discussion begs the question of what lender control in the DIP financing context is, so that it is possible to analyze its implications. In order to examine the concept of control, an intermediate step needs to be taken. The notion of what a firm is, the element over which control can potentially be exerted, needs to be unveiled to figure out the possible contents and boundaries of the definition of control. Understanding what constitutes the firm will determine those limits in the set of possible control scopes, while also informing how amenable control is to concentration under different conceptualizations of the firm.

This section will delve into the theory of the firm in order to carry forward some conclusions to help understand what control signifies and what the consequences of its allocation to a secured creditor are. Control applies potentially to the elements of the economic firm. In this sense, the scope of control has an upper limit determined by what the firm's elements are. This is not to say that the strength of control depends merely on what the elements of the firm and the legal entitlements are.<sup>76</sup> It means that recognizing the limitations that a static analysis may have (shying away from questions such as how the definition of the firm and its governance may affect

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<sup>76</sup> Compliance with authority, for example, has a cultural understanding and different ways to respond to authority may generate different values to firms. For a comprehensive study on the effects of authority see Stanley Milgram "Obedience to Authority: An Experimental View", Harpercollins, New York, NY (1974).

responses to authority), the definition of the economic firm will shape what the scope of control could potentially be. The possibility of control concentration is also informed by the theory of the firm concept that is adopted, because the lesser the commodifiability of a firm element the more difficult it will be to concentrate control (due to the non-appropriability of the other elements of the firm).<sup>77</sup> Scope and concentration control levels govern an individual's (i.e. DIP lender) ability to protect firm value.

Investigating the firm elements will also provide clues in order to assess firm value. Different firm theories will conceive value as arising from different sources. As there is a connection between possible control definition and allocations and firm value, this section will also discuss the implications of different theories of the firm on its valuation. The incidence of control allocation on firm value will be discussed in greater detail *infra* in section IV.

The theory of the firm has proven to be a fruitful field for research purposes in recent years. Many papers and books have looked at what the firm is, creating a host of theories.<sup>78</sup> Such a proliferation of theories will make the account that follows

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<sup>77</sup> For example, Nickerson and Zenger believe that the characteristic of the problem to be solved implicates the organizational form. If a problem is decomposable (low interaction is needed among knowledge sets, hence problems can be decomposed into sub-problems), a market solution is appropriate as it provides weak incentives for knowledge sharing. If the problem is of moderate interaction (sub-problems can be identified, but the value of the solution depends on the interaction of the sub-solutions), an authority-based search is better suited, because it efficiently handles the tradeoff between economizing on the transmission and handling of information due to the presence of a central figure that understand critical knowledge interactions with the costs arising out of the cognitive limits of managers and the overconfidence in their own judgment. Finally, if a problem requires high interaction (the complexity of the problem is so big that no knowledge set by itself is sufficient to solve the problem), a consensus-based hierarchy, which substitutes education for direction and is better at achieving a common language, is appropriate as it resolves disputes based on consensus and has low powered incentives which discourages knowledge hoarding. See, generally, Jack A. Nickerson & Todd R. Zenger "A Knowledge-Based Theory of the Firm – The Problem-Solving Perspective", 15 *Organization Science* 617 (2004).

<sup>78</sup> For example see Margaret M. Blair "Firm-Specific human Capital and Theories of the Firm", in *EMPLOYEES AND CORPORATE GOVERNANCE*, Margaret M. Blair and Mark J. Roe, eds.,

necessarily incomplete and perhaps unsubtle. Nonetheless, and given the difficulties in covering every proposed idea in depth, the subsequent discussion will try to highlight broad categories of existing theories of the firm to serve as a background when analyzing TEB understanding of the firm in the bankruptcy scenario.

### A. Neoclassical theory

The neoclassical theory views firms in terms of the technological transformations which they are capable of employing.<sup>79</sup> The focus is set on the maximization of the production function of the firm, because firms are assumed to “deal in markets for homogeneous commodities.”<sup>80</sup> In a simple description, which assumes perfect competition in the output market, the theory maintains that the firm will attempt to produce so that its marginal cost matches the output price.<sup>81</sup> Milgrom and Roberts suggest that the neoclassical theory looked at market failures in

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Brookings Institution Press, 1999; Nicolai J. Foss “The Knowledge Governance Approach”, 14 *Organization* 29 (2007); Jack A. Nickerson & Todd R. Zenger “A Knowledge-Based Theory of the Firm – The Problem-Solving Perspective”, 15 *Organization Science* 617 (2004); Cheryl Carleton Asher, James M. Mahoney & Joseph T. Mahoney “Towards a Property Rights Foundation for a Stakeholder Theory of the Firm”, 9 *Journal of Management and Governance* 5 (2005); Bengt Holmström & John Roberts “The Boundaries of the Firm Revisited”, 12 *Journal of Economic Perspectives* 73 (1998); Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623 (2000); Erica Gorga & Michael Halberstam “Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge Based Theory of the Firm”, 101 *Northwestern L. Rev.* 1123 (2007); Raghuram G. Rajan & Luigi Zingales “Power in a Theory of the Firm”, 113 *Quarterly Journal of Economics* 387 (1998); Oliver Hart & John Moore “Property Rights and the nature of the Firm”, 98 *Journal of Political Economy* 1119 (1990); etc.

<sup>79</sup> See Sidney G. Winter “On Coase, Competence, and the Corporation”, 4 *Journal of Law, Economics, & Organization* 163, 164 (1988). Also, see Oliver E. Williamson “Corporate Finance and Corporate Governance”, 43 *Journal of Finance* 567,569 (1988). For an early presentation of the neoclassical viewpoint, see Jacob Viner “Cost Curves and Supply Curves”, 3 *Zeitschrift für National-ökonomie* 23 (1932). Hart considers that “A manager presides over this production set, buying and selling inputs and outputs in a spot market and choosing the plan that maximizes owners' welfare.” See Oliver Hart “An Economist's Perspective on the Theory of the Firm”, 89 *Colum. L. Rev.* 1757, 1759 (1989).

<sup>80</sup> See Sidney G. Winter “On Coase, Competence, and the Corporation”, 4 *Journal of Law, Economics, & Organization* 163, 164 (1988). Holmstrom and Tirole argue that the theory of the firm in neoclassical terms just asked “what forces ensure that the process will maximize profits”. See Bengt R. Holmstrom & Jean Tirole “The Theory of the Firm”, 1 *Handbook of Industrial Organization* 61, 63 (1989).

<sup>81</sup> See Oliver Hart “Firms, Contracts, and Financial Structure”, Oxford University Press, New York (1995), p. 18.



competitive environments to find reasons for non-market organizations, among which they mention market power, increasing returns to scale, externalities, missing markets, and search, matching and coordination problems.<sup>82</sup>

The neoclassical conceptualization fails to address important structural issues while at the same time making non evident assumptions. Because the neoclassical theory rationalizes the firm as a sort of black box which transforms inputs into outputs, it circumscribes the object of study to the analysis of how the firm can maximize its production. Therefore, the neoclassical theory doesn't pay any attention to how things work inside the firm and has nothing to say about internal firm organization.<sup>83</sup> As a related consequence, the concentration on the technology employed fails to supply a "genuine trade-off between integration and non-integration."<sup>84</sup> Finally, the neoclassical theory takes as a given the information set necessary for production, effectively treating knowledge as an exogenous factor.<sup>85</sup>

According to the neoclassical theory value arises from a given production function, with the typical sources being scale or scope economies. Therefore, if the firm has value outside of bankruptcy, it will maintain it in bankruptcy, because initiating the bankruptcy proceeding does not change that production function. As the neoclassical theory doesn't say anything about which elements constitute the firms,

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<sup>82</sup> See Paul R. Milgrom & John Roberts, *ECONOMICS, ORGANIZATION & MANAGEMENT*, Prentice Hall, Englewood Cliffs, N.J. (1992), at 73-7.

<sup>83</sup> See Oliver Hart "Firms, Contracts, and Financial Structure", Oxford University Press, New York (1995), p. 17.

<sup>84</sup> See Bengt R. Holmstrom & Jean Tirole "The Theory of the Firm", 1 *Handbook of Industrial Organization* 61, 66 (1989).

<sup>85</sup> Winter argues that "By taking production sets or functions as given, [neoclassical theory] fails to provide for a framework for explaining why society's capabilities should be packed at a particular time in one particular way and not some other way... Most importantly, textbook orthodoxy fails to provide a basis for understanding the incentives and processes in business firms that produce technological and organizational change." See Sidney G. Winter "On Coase, Competence, and the Corporation", 4 *Journal of Law, Economics, & Organization* 163, 171 (1988).

control scope remains an undefined and open subject. In addition, the lack of precision on what constitutes the firm's elements doesn't rule out any concentration option. Ergo, full control concentration appears as a possibility.

### **B. Nexus of explicit contracts**

The explicit nexus of contracts view of the firm is prevalent in corporate finance<sup>86</sup> and arguably also in corporate governance. The idea was originated with Alchian and Demsetz's<sup>87</sup> study of organizational forms which would permit a lower cost of detecting shirking in a team production setting. Specifically, Alchian and Demsetz analyzed a situation where output from a joint venture, for example a university, could be verified but input from different individuals could not.<sup>88</sup> As free riding would emerge among members of the team, they propose to allow one person (i.e. a manager) to be the central party common to all contracts, to monitor the venture ("observe input behavior"), pay the other individuals fixed amounts and to be rewarded by receiving all the residual claims from the firm.<sup>89</sup>

Jensen and Meckling<sup>90</sup> contributed greatly to this approach by clearly defending a view of the firm as an explicit nexus of contracts where the firm is a legal

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<sup>86</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1630 (2000).

<sup>87</sup> See Armen Alchian & Harold Demsetz "Production, Information Costs and economic Organization", 62 American Economic Review 777 (1972).

<sup>88</sup> "What a team offers to the market can be taken as the marginal product of the team but not of the team members." See Armen Alchian & Harold Demsetz "Production, Information Costs and economic Organization", 62 American Economic Review 777, 780 (1972).

<sup>89</sup> See Bengt R. Holmstrom & Jean Tirole "The Theory of the Firm", 1 Handbook of Industrial Organization 61, 67 (1989). Central in Alchian and Demsetz's conception was to find a way to meter input productivity and rewards in a team production setting and to therefore be able to tie these two concepts in such a way that changes in "rewards fall on those responsible for changes in output." See Armen A. Alchian & Harold Demsetz "Production, Information Costs and economic Organization", 62 American Economic Review 777, 778 (1972).

<sup>90</sup> See Michael C. Jensen & William H. Meckling "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 4 Journal of Financial Economics 305 (1976).

fiction whose purpose is to tie a set of contractual relations.<sup>91</sup> As a result, the boundaries of the firm are set by the costs the monitor (i.e. the manager) incurs in controlling that each agent performs according to the contract obliging her.<sup>92</sup> In their conceptualization, the firm will achieve optimal size when the marginal increment in value due to size is equal to the marginal increment in loss involved in the consumption of additional fringe benefits by any of the agents.<sup>93</sup>

This approach generates several implications. As by assumption all contracts are explicit, the firm cannot be worth more than the sum of contracts it unites, making any sub-partition as valuable inside as outside the firm as long as the same monitoring and producing technology applies.<sup>94</sup> The explicit nexus of contracts assumes that each constituent, but the shareholders, is fully paid its opportunity cost. Therefore,

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<sup>91</sup> See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 311 (1976). It is important to note that Alchian and Demsetz assigned a smaller relative weight to contracting costs vis a vis the detection of individual team members’ performance. See Armen A. Alchian & Harold Demsetz “Production, Information Costs and economic Organization”, 62 *American Economic Review* 777, 782 (1972).

<sup>92</sup> Jensen and Meckling define an agency relationship as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.” See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 308 (1976). Then agency costs are composed of “1. the monitoring expenditures by the principal, 2. the bonding expenditures by the agent, 3. the residual loss.” See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 322-3 (1976).

<sup>93</sup> See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 311 (1976).

<sup>94</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1631 (2000). In Jensen and Meckling words “The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. Although this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other organizations focuses attention on a crucial set of questions—why particular sets of contractual relations arise for various types of organizations, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization. Viewed this way, it makes little or no sense to try to distinguish those things that are “inside” the firm (or any other organization) from those things that are “outside” of it.” See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 311 (1976).

allocating decision rights to shareholders as residual claimants easily follows, because they are the only constituents of the firm bearing immediate risks.<sup>95</sup> Following the same logic, only shareholder interests should be pursued by the firm. As a corollary consequence, in order to value the firm computing only share price is important, so long as the firm is solvent.

The nexus of explicit contracts theory has some shortcomings. Assuming the existence of explicit contracts only seems to generate a stark contrast with reality. Fama and Miller have pointed out that bondholders are not completely protected from shareholder decision making and therefore also incur risks.<sup>96</sup> Becker points to worker's specialization to observe that those employees can be affected if the firm fires them before they recoup the investment in specialization and therefore are residual claimants also.<sup>97</sup> Shleifer and Summers studied efficiency gains of takeovers to conclude that at least in part they arise out of wealth redistribution from stakeholders to shareholders (the redistribution of wealth may come from employees, government or suppliers).<sup>98</sup> Finally, Peterson and Rajan while discussing the reasons

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<sup>95</sup> Easterbrook and Fischel consider that "As the residual claimants, the shareholders are the group with the appropriate incentives (collective choice problems to one side) to make discretionary decisions... Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion." See Frank H. Easterbrook & Daniel R. Fischel "Voting in Corporate Law", 26 Journal of Law and Economics 395, 403 (1983).

<sup>96</sup> See Eugene Fama & Merton H. Miller THE THEORY OF FINANCE, Dryden Press, Hinsdale, Ill. (1972)

<sup>97</sup> Gary S. Becker Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education, National Bureau of Economic Research, New York (1964). Yair Listokin provides a clear example: "organization breach implicit contracts, which are not legally enforceable.27 For example, organizations may induce effort and investment in younger employees by promising above market wages in later years as a reward for good performance. Good performance may be unverifiable, however, so the agreement cannot be reduced to contract. As a result, the controlling patrons can have the organization renege on the implicit contract if it suits the controlling patrons' interest." See Yair Listokin "The Pivotal Mechanism and Organizational Control", working paper available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1372822](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1372822) (last checked 04/07/09), page 7.

<sup>98</sup> See Andrei Shleifer & Lawrence H. Summers. "Breach of Trust in Hostile Takeovers", *Corporate Takeovers: Causes and Consequences*, edited by Alan J. Auerbach, pp. 33-56. Chicago: The University of Chicago Press (1988). They contended that firms usually rely on implicit contracts which the

which explain the existence of trade credit mention that, provided that the trading relationship will continue, also trade suppliers have an implicit equity stake on the customer's firm.<sup>99</sup> Therefore, even though shareholders are the only *de jure* residual claimants in the nexus of contracts, it doesn't mean that they are the only *de facto* residual claimants. In fact, the very notion of the existence of a single class of residual claimants has been questioned.<sup>100</sup>

To recap, the nexus of explicit contracts notion views the firm as the mere sum of its parts.<sup>101</sup> Therefore, any going concern value that a firm may have needs to arise necessarily from the transaction costs<sup>102</sup> that could be saved from not having to put back together the web of contracts already in place.<sup>103</sup> It does not necessarily follow that the interconnection of contracts is valuable but provided that it is, the value of a firm under the nexus of explicit contracts has an upper limit determined exogenously by search and information costs, bargaining and decision costs. If technological advances reduce these costs, as TEB has suggested happened, then the value to be

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company must be trusted to respect. To the extent that long term contracts reduce costs, such trustworthiness is a valuable asset to the firm. The need for long term contracts derives from the equal need to promote firm specific investment. The problem is that even if ex ante efficient, in certain states of the world it will be ex post efficient to breach those contracts. Hence, ex post cost breaching needs to be measured against ex ante increase in cost (plus it is more likely to be, at least in part, a redistribution of wealth than anything else).

<sup>99</sup> See Mitchell A. Peterson & Raghuram G. Rajan "Trade Credit: Theories and Evidence", 10 The Review of Financial Studies 661, 669 (1997). ("Furthermore, if a firm and its supplier continue to transact in the future, the supplier has an implicit equity stake in the firm equal to the present value of the margins he makes on current and future sales of the product to the firm. This may far exceed the implicit equity stake a financial institution may have because of the potential for future business, and may explain why suspect growing firms tend to be financed by suppliers.")

<sup>100</sup> Milgrom and Roberts suggest that "it may be impossible to identify any individual or group that is the unique residual claimant or, indeed, to identify the benefits and costs accruing to any decision and so compute the residuals." See Paul R. Milgrom & John Roberts, *ECONOMICS, ORGANIZATION & MANAGEMENT*, Prentice Hall, Englewood Cliffs, N.J. (1992), at 315.

<sup>101</sup> See section II.B.2 *supra*.

<sup>102</sup> Richard Posner defines transaction costs as "the costs involved in organizing economic activity through voluntary exchange". See Richard A. Posner, *ECONOMIC ANALYSIS OF LAW*, Aspen Publishers, New York, NY, seventh edition (2007), at 419.

<sup>103</sup> This statement assumes that either each member of the organization is replaceable or that each member could be potentially rehired.

protected in bankruptcy diminishes also.<sup>104</sup>

As for control, the nexus of explicit contracts theory proclaims that a firm's elements arise out of the web of agreements which constitute the firm.<sup>105</sup> Naturally, the scope of potential control then can be defined only over the uses of the rights arising of those contracts. In other words, as the firm purchases each of the inputs necessary for production and those are readily replaceable by equal quality ones, control (and its scope) is merely a contractual concept. Consequently, and irrespective of whoever this control is specifically allocated to,<sup>106</sup> the controlling party will be able to determine what the use of the inputs for the periods acquired will be (within the restrictions that each contract provides for). At least theoretically then, control can be fully concentrated (i.e. one person can be the owner of those rights and decide on the usage, or delegate to a manager that decision).

### **C. Nexus of explicit and implicit contracts**

The previous theory relies on a fairly rigid set of assumptions. Baker, Gibbons and Murphy relax some of those assumptions and put forward an alternative, perhaps more plausible, theory. They believe that

“[F]irms are riddled with relational contracts: informal agreements and unwritten codes of conduct that powerfully affect the behaviors of

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<sup>104</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 778-9 (2002).

<sup>105</sup> The usage of control is generally employed in a negative sense in this literature, referring to ways to reduce agency costs. Jensen and Meckling, for example, consider control as a way to limit an agent's behavior. See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 Journal of Financial Economics 305, 308-10 (1976). Nonetheless, the idea of control applied to bankruptcy has a positive nature, as it implies decision-making. Therefore, due to the focus of this paper, the notion of control is constructed in a positive way.

<sup>106</sup> Alchian and Demsetz believe that control should be allocated to equity because they have the best incentives to lead the team when global outputs are easily measurable but not individual contribution to the output. See Armen Alchian & Harold Demsetz “Production, Information Costs and economic Organization”, 62 American Economic Review 777, 781-3 (1972).

individuals within firms.”<sup>107</sup>

These informal agreements, or implicit contracts, serve to circumvent problems such as non-observability (i.e. moral hazard) or non-verifiability (i.e. non-contractability) of outcomes by third parties. The informality of implicit contracts makes them highly adaptable to unforeseen situations but, as a drawback, they can merely be self-enforced. As a result, implicit contracts are not available on demand and require the development of trust and the formation of reputation (firm reputation in the situation under study), which can only be achieved through the passage of time.<sup>108</sup>

The nexus of implicit and explicit contracts conception of the firm presents a more complex structure, introducing the important interaction between formal and informal agreements.<sup>109</sup> Because of being constituted by both types of arrangements, the firm can be worth more (or even less) than the sum of its individual parts depending on the value of the particular investments. As a result, the economic definition of the firm may differ from the legal one, as corporations are not viewed as owning informal relations, specifically non-contracted upon ones.<sup>110</sup> For example, relational suppliers may generate value, but that value generally is not considered to technically belong to the firm.<sup>111</sup>

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<sup>107</sup> See George Baker, Robert Gibbons & Kevin J. Murphy “Relational Contracts and the Theory of the Firm”, 117 *Quarterly Journal of Economics* 39, 39 (2002). As examples they mention “informal quid pro quos between coworkers, as well as unwritten understandings between bosses and subordinates about task-assignment, promotion, and termination decisions... long-run, hand-in-glove supplier relationships through which the parties reach accommodations when unforeseen or uncontracted for events occur. Similar relationships also exist horizontally, as in the networks of firms in the fashion industry or the diamond trade, and in strategic alliances, joint ventures, and business groups.” See George Baker, Robert Gibbons & Kevin J. Murphy “Relational Contracts and the Theory of the Firm”, 117 *Quarterly Journal of Economics* 39, 39-40 (2002).

<sup>108</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1633 (2000).

<sup>109</sup> See George Baker, Robert Gibbons & Kevin J. Murphy “Relational Contracts and the Theory of the Firm”, 117 *Quarterly Journal of Economics* 39, 70-1 (2002).

<sup>110</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1634 (2000).

<sup>111</sup> Chaver and Fried address the existence of implicit contracts and, as a result, challenge the conceived financial value maximization standard (which tries to maximize the value to creditors and shareholders) in the eve of insolvency as insufficient, because performance creditors are not accounted for in that

A notable corollary for bankruptcy purposes is that, under this understanding, the firm's capital structure increases its importance because liquidity shocks can diminish the value of the firm's implicit contracts, perhaps in a permanent manner. If a firm loses the reputation it has for respecting implicit contracts due to financial restrictions, then the value to the firm itself and the mere sum of the individual assets' value may tend to converge, because the credibility of the firm's promises would diminish.<sup>112</sup> As a result, the implicit and explicit nexus of contracts theory regards the firm as having other residual claimants besides equity holders, due to the fact that other stakeholders' may also have an investment in the relation.

As we mentioned, the nexus of implicit and explicit contracts theory recognizes the existence of value outside mere transaction costs. Implicit contracts are difficult to understand and value, but their existence implies that there are hidden assets in an organization.<sup>113</sup> As a consequence, the mere aggregation of financial claims may not accurately represent the value a firm has. Focusing on financial claims to decide what to do with the assets of a distressed firm will turn out as a suboptimal option because it may disrupt an asset ownership and control structure which allows for a given promise to be self enforcing.<sup>114</sup>

The explicit and implicit nexus of contracts theory shares with the nexus of explicit contracts the view that control crops up out of the web of agreements that constitutes the firm. As seen before, implicit contracts are naturally self-enforcing due

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standard. See Alon Chaver & Jesse M. Fried "Manager's Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors", 55 Vand. L. Rev. 1813 (2002).

<sup>112</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1634 (2000).

<sup>113</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1635 (2000).

<sup>114</sup> See George Baker, Robert Gibbons & Kevin J. Murphy "Relational Contracts and the Theory of the Firm", 117 Quarterly Journal of Economics 39, 41 (2002).



to their informality therefore the potential scope of control is comprised by legal rights and non legal ones. Explicit contracts allocation of control can be done in the same way as in the nexus of explicit contracts theory, but implicit contracts control rights are split between the parties to those contracts who have full control on whether to honor them or not. In an end game situation like bankruptcy, a breach of the implicit contracts could be made without paying for the informal consequences.<sup>115</sup> As a result of these arguments, full control concentration under this theory is impossible. Additionally, control transfers may not be neutral to the content of the firm and, hence, indirectly to control itself.

#### **D. Property rights approach**

The property rights theory of the firm has developed from a seminal paper by Grossman and Hart which was followed by another important article by Hart and Moore.<sup>116</sup> These authors believe that firms are collections of non-human assets.<sup>117</sup> Having property rights over those assets becomes important because complete contracts are infeasible and/or too costly. Then, because contracts are incomplete,<sup>118</sup> having asset ownership grants the possibility, referred to as having residual control rights, to decide in an unconstrained fashion on the use of those assets upon the occurrence of a non- prearranged situation.<sup>119</sup> In Hart's words

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<sup>115</sup> Peterson and Rajan discuss this possibility specifically in the case of trade creditors. See Mitchell A. Peterson & Raghuram G. Rajan "Trade Credit: Theories and Evidence", 10 *The Review of Financial Studies* 661, 675 (1997).

<sup>116</sup> See Sanford J. Grossman & Oliver D. Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", 94 *Journal of Political Economy* 691 (1986); Oliver Hart & John Moore "Property Rights and the nature of the Firm", 98 *Journal of Political Economy* 1119 (1990).

<sup>117</sup> See Oliver Hart, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE*, Oxford University Press, New York (1995), p. 56.

<sup>118</sup> Williamson considers that incomplete contracts mean that "parties will be cognizant of prospective distortions and of the needs to (1) realign incentives and (2) craft governance structures that fill gaps, correct errors, and adapt more effectively to unanticipated disturbances." See Oliver E. Williamson "Corporate Finance and Corporate Governance", 43 *Journal of Finance* 567, 570 (1988).

<sup>119</sup> Grossman and Hart explain the problem of costly contracts in these terms "We present a theory of costly contracts that emphasizes that contractual rights can be of two types: specific rights and residual

“The owner of an asset has residual control rights over the asset: the right to decide all usages of the asset in a way not inconsistent with prior contract, custom, or law.”<sup>120</sup>

The property rights theory of the firm maintains that the allocation of residual decision rights via ownership can have an effect on investments in relationship specific capital (one which has lesser or no value outside the relation for which is created) and, thereby, on overall efficiency. As residual control rights partially determine ex post distribution of surplus, how the residual rights are allocated will determine the parties’ willingness to invest ex ante. Therefore, efficiency will be served by ex ante allocating asset ownership in proportion to the relation specific investment that parties make. For example, Hart mentions the case of GM ownership of Fisher Body, as well as electricity generating plants owning coal mines or aluminum refineries owning bauxite mines.<sup>121</sup> According to this theory, joint asset ownership, because several parties can make valuable firm specific investments, explains the more sophisticated firm structures.

Zingales believes that a very appealing feature of this theory is to make the economic notion of the firm amenable to legal theory,<sup>122</sup> because it is easier to associate a corporation with the assets it formally owns rather than, for example, the

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rights. When it is too costly for one party to specify a long list of the particular rights it desires over another party’s assets, it may be optimal for the party to purchase all rights except those specifically mentioned in the contract. Ownership is the purchase of these residual rights of control.” See Sanford J. Grossman & Oliver D. Hart “The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration”, 94 *Journal of Political Economy* 691, 692 (1986).

<sup>120</sup> See Oliver Hart, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE*, Oxford University Press, New York (1995), p. 30. Holmstrom and Tirole emphasize that the contracts that shape the residual control rights are explicit. See Bengt R. Holmstrom & Jean Tirole “The Theory of the Firm”, 1 *Handbook of Industrial Organization* 61, 69 (1989).

<sup>121</sup> See Oliver Hart, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE*, Oxford University Press, New York (1995), p. 29- 33, 50-1.

<sup>122</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1638 (2000).

labor force it employs. Regardless of the validity of such claim (Zingales never discloses what the *legal* theory of the firm under his view, or anyone else's, is), the property rights approach has been undoubtedly ground breaking. Nonetheless, it has been subject to criticism. A commonly mentioned problem of the property rights approach is the identification of ownership and control,<sup>123</sup> which has been shown to differ in many corporations since the extant writings of Berle and Means. Another difficulty arises from the narrow scope which this theory has, as it does not take into account human capital as being part of the firm.<sup>124</sup> Finally, as is discussed above with the nexus of explicit contracts theory, the value of the firm is represented only by the sum of the assets the firm owns, which provides little explanatory power for the role of equity.

As we saw, the property rights approach starts from asset ownership to explain a firm's existence in terms of ex ante incentives to parties that will make them generate efficient complementarities. Therefore, physical assets' and their allocation will determine the value of the firm by increasing or reducing hold up power.<sup>125</sup> The

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<sup>123</sup> See for example John Kay, *THE BUSINESS OF ECONOMICS*, Oxford University Press, Oxford (1996), at 111; Erica Gorga & Michael Halberstam "Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge Based Theory of the Firm", 101 *Northwestern L. Rev.* 1123, 1136 (2007).

<sup>124</sup> See Margaret M. Blair "Firm-Specific human Capital and Theories of the Firm", in *EMPLOYEES AND CORPORATE GOVERNANCE*, Margaret M. Blair and Mark J. Roe, eds., Brookings Institution Press, 1999, at 66. See, also, Luigi Zingales "In search for New Foundations", 55 *Journal of Finance* 1623, 1639 (2000) ("However, by defining the firm as a collection of assets, the property rights view excludes the insider's human capital.")

<sup>125</sup> Referring to the famous GM-Fischer Body integration problem, Hart gives the following example: "Anticipating the way surplus is divided, GM will typically be much more prepared to invest in machinery that is specifically geared to Fisher bodies if it owns Fisher than if Fisher is independent, since the threat of expropriation is reduced. The incentives for Fisher, however, may be quite the opposite. Fisher management will generally be much more willing to come up with cost-saving or quality-enhancing innovations if Fisher is an independent firm than if it is part of GM, because Fisher management is more likely to see a return on its activities. If Fisher is independent, it can extract some of GM's surplus by threatening to deny GM access to the assets embodying these innovations. In contrast, if GM owns the assets, Fisher management faces total expropriation of the value of the innovation to the extent that the innovation is asset-specific rather than management-specific, and GM can threaten to hire new management team to incorporate the innovation." See Oliver Hart "An Economist's Perspective on the Theory of the Firm", 89 *Colum. L. Rev.* 1757, 1768-9 (1989).

former understanding leads Zingales to believe that firm value is identified with what the owner can extract as private benefits.<sup>126</sup> Zingales arrives at this conclusion because the specific investment by the owner, perhaps due to its ability to generate complementarities, is what creates the extra surplus making the firm valuable.

The property rights theory of the firm, as mentioned above, considers control rights or, with more precision, residual control rights to be the basis for conceiving ownership.<sup>127</sup> This approach does not differentiate between ownership and control, so both are commingled and inseparable. The concept of control here can be understood as a way “to foster and protect relationship specific investments.”<sup>128</sup> As the property rights approach focuses on non-human assets, the scope of control would appear to exclude them. Nonetheless, firm value (and allocation of ownership) is dependent on relations between human and non-human assets. Ergo, the scope of control could potentially cover not only non-human assets but also specific investments, with the caveat that the later is non transferable. As a result, full control concentration and transfer may not be achieved under the property rights approach to preserve (ex post) and create (ex ante) firm value.

### **E. Nexus of Specific Investments**

Building on the theoretical framework of the property rights approach, Rajan

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<sup>126</sup> See Luigi Zingales “In search for New Foundations”, 55 Journal of Finance 1623, 1639 (2000)

<sup>127</sup> “The market can function only in a situation where the “exclusion principle” applies, i.e. where A’s consumption is made contingent on A’s paying the price, while B, who does not pay, is excluded. Exchange cannot occur without property rights, and property rights require exclusion. Given such exclusion, the market can function as an auction system.” See Richard A. Musgrave & Peggy B. Musgrave, PUBLIC FINANCE IN THEORY AND PRACTICE, McGraw-Hill College 55 (3d ed. 1980).

<sup>128</sup> See Raghuram G. Rajan & Luigi Zingales “Power in a Theory of the Firm”, 113 Quarterly Journal of Economics 387, 387 (1998). As they explain, “the smaller the space of contracts that can be written and enforced, the more important the role of residual rights of control.”

and Zingales have proposed a view of the firm as a nexus of specific investments,<sup>129</sup> considering that it is not just physical assets' ownership that generates power "nor necessarily the most efficient in promoting relation specific investments."<sup>130</sup> Zingales affirmed that

"[W]hat distinguishes the firm from the market is the web of specific investments built around a critical resource... By controlling a critical resource an entrepreneur can influence the accumulation of specific investments so as to build complementarities between the person the entrepreneur seeks to have power over and her critical resource."<sup>131</sup>

The nexus of specific investments theory of the firm allows chronological differentiation of what the firm is considered to be:

"[B]efore investment [in specialized human capital] takes place, the firm is defined by who holds the ownership rights to the physical assets that are required for production and by who is given access to the physical assets."<sup>132</sup>

Once the specific investments have been undertaken,

"the firm is defined by the ownership of the physical assets and the power that accrues to those who have made specific investments."<sup>133</sup>

Eventually, if the firm keeps on being successful in its development, at some point the web of specific investments may become so important and distinct from the mere sum of the parts it is composed of that the web itself turns out to be the critical resource

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<sup>129</sup> See Raghuram G. Rajan & Luigi Zingales "Power in a Theory of the Firm", 113 Quarterly Journal of Economics 387 (1998); Raghuram G. Rajan & Luigi Zingales "The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms", 116 Quarterly Journal of Economics 805 (2001).

<sup>130</sup> See Raghuram G. Rajan & Luigi Zingales "Power in a Theory of the Firm", 113 Quarterly Journal of Economics 387, 388 (1998).

<sup>131</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1645 (2000).

<sup>132</sup> See Raghuram G. Rajan & Luigi Zingales "Power in a Theory of the Firm", 113 Quarterly Journal of Economics 387 (1998).

<sup>133</sup> See Raghuram G. Rajan & Luigi Zingales "Power in a Theory of the Firm", 113 Quarterly Journal of Economics 387 (1998).

around which more specific investments could be made.<sup>134</sup>

The nexus of specific investments' view of the modern firm is influenced by the assessment that physical assets are less unique and hence command less rents than before, as in Chandler's traditional firm,<sup>135</sup> and by the difficulty in appropriability of human capital (i.e. no slavery). Complementarily, increased competition at the worldwide level augmented the demand for innovation which has been translated into more rents to human capital.<sup>136</sup> But increased competition changed the game in another important way: a firm's grip on employees has diminished due to the increased access to financing and employment opportunities.<sup>137</sup> Increased financing leads to exploration of alternative ways of exploiting business opportunities by those who know them best and to the creation of additional organizational structures which obviously require manpower (i.e. new jobs). Despite the several intriguing aspects of this theory, it does face some challenges. On this regard, one of the hardest challenges arises out of the fuzzy definition of access, leading up to some indeterminacy.

This theory, like the nexus of explicit and implicit contracts one, generates a

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<sup>134</sup> This is a way of explaining the creation and existence of reputation or organizational capital, though I am not aware of any formalization of reputation creation in this way.

<sup>135</sup> See, generally, Alfred D. Chandler, Jr. "Scale and Scope. The Dynamics of Industrial Capitalism", The Belknap Press of Harvard University Press, Cambridge, MA (1990), at 3-46

<sup>136</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1642 (2000).

<sup>137</sup> Rajan and Zingales provide several illustrations of the smaller grip a firm has on key employees. For example "Intel, the microprocessor manufacturer, was started, not in a garage or basement as many other Silicon Valley start-ups, but when Robert Noyce, the General Manager of Fairchild Semiconductor, and Gordon Moore, its head of Research and Development walked out of Fairchild and set up their own firm, Integrated Electronics. Shortly before their departure, a scientist in Moore's department had discovered the "silicon-gate" technique to produce semiconductor memory devices. This became an important part of Intel's proposed product line... Clearly, of all Fairchild's employees, Noyce and Moore had the greatest access to Fairchild's inventions, and at the very least, took a lot of knowledge and, equally important, employees with them to the start-up. Thus, Intel hit the ground running, and is now one of the most profitable firms while Fairchild Semiconductor is virtually a footnote in business history." See Raghuram G. Rajan & Luigi Zingales "The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms", 116 Quarterly Journal of Economics 805, 806 (2001).

plausible explanation to the existence of indirect bankruptcy costs.<sup>138</sup> Reorganizations and to a greater extent liquidations, irrespective of being due to either financial or economic reasons, may destruct value if they signal to employees that their specific investment may become less valuable, in turn reducing the value of organizational capital. As a result of the magnitude and alleged irreparable condition of the bankruptcy costs, the nexus of specific investment theory believes that the role of equity may have mutated from its financing nature into some sort of insurance mechanism that protects the long term viability of the enterprise.<sup>139</sup>

As for firm governance, it is heavily affected by the particular implications of the nexus of specific investments theory. The fact that power is dispersed among constituents shifts the governance focus into the prevention of conflicts between stakeholders. Besides the need to take into account conflicting objectives, the dispersion of power among different stakeholders' risks, in the extreme, the destruction of firm value as no party fully internalizes the preservation of organizational capital.<sup>140</sup> Therefore, Zingales considers that the principal role for firm governance is

“to ensure an alignment between the ability to capture the opportunities and reward stemming from them.”<sup>141</sup>

The nexus of specific investments theory does not generate all the answers in

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<sup>138</sup> On bankruptcy costs see Edward I. Altman “A Further Empirical Investigation of the Bankruptcy Cost Question”, 39 *Journal of Finance* 1067 (1984); Theodore Eisenberg “Baseline Problems in Assessing Chapter 11”, 43 *University of Toronto Law Journal* 633 (1993); Arturo Bris, Ivo Welch & Ning Zhu “The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization”, 61 *Journal of Finance* 1253 (2006); Maria Carapeto “Is Bargaining in Chapter 11 Costly?”, Cass Business School Working Paper (2003).

<sup>139</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1647 (2000).

<sup>140</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1648 (2000).

<sup>141</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1649 (2000).

terms of how to value a firm. This theory is premised upon the fact that

“what keeps the firm together is the strong complementarity between human and physical assets. Thus, an option “belongs” to the firm if it is highly complementary with the physical and human capital that constitutes the firm.”<sup>142</sup>

With this information, some conclusions follow which are of interest for bankruptcy purposes. First, firms consist of more than the mere value of the physical assets they have ownership over. Second, value may not reside “inside” the legal notion of the firm.<sup>143</sup> Finally, value may be very volatile and can be easily lost due to human capital mobility, which probably helps to explain bankruptcy indirect costs’ positive correlation with the duration of the proceedings.<sup>144</sup>

The nexus of specific investments understanding of control is likely the more complex of all the theories discussed above. This theory explains that the sources of control arise from the existence of critical resources. A critical resource could start from the ownership of physical assets, but then specialization of human capital will trump the role of being the critical resource. The elements of the firm are then comprised by human (non-transferable) as well as non-human assets. Therefore, control scope is potentially applied to those elements. As a consequence of the non-transferability of some elements of the firm, control is necessarily dispersed and shared by those who own critical resources. As a result, the ability to exercise control by the owners of physical assets is heavily constrained by the power achieved through human capital specialization. Then, if human and physical critical resources are not

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<sup>142</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1649-50 (2000).

<sup>143</sup> As mentioned above, there’s an important caveat: it is not clear what the legal notion of the firm is under this theory.

<sup>144</sup> See Edward I. Altman “A Further Empirical Investigation of the Bankruptcy Cost Question”, 39 *Journal of Finance* 1067 (1984);



owned by the same person, full control concentration is impossible.

## **F. Implications for this paper**

As it was highlighted throughout this section, the understanding of what constitutes a firm is of utmost importance. Ramifications emanating from those conceptions will eventually play a fundamental role in answering where a distressed firm's value stems from. In turn, this answer will help to evaluate whether creditor control is optimal to realize firm value, in other words, whether control allocation matters. Of course, the definition of the firm will not be the only element employed to determine the most efficient bankruptcy control allocation, but each particular definition will play an important role in determining the set of feasible answers to the allocation question. As each particular theory has the potential to determine different sets of answers, the selection of a theory of the firm won't be trivial.

This section's discussion helps in understanding that value depends on what we see the firm as being. As soon as it is recognized that value arises out of non physical, potentially non transferable assets or that value is not fully covered by financial claims to the legal firm,<sup>145</sup> then the importance of who is assigned control grows. In that case, the decision-maker may need to take into account other elements besides physical asset value or saving on transaction costs (both values being exogenous to the decision-maker action choice), as basically proposed by TEB.

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<sup>145</sup> A good example of the difficulty in explicitly defining contract terms is given by Blumenstein and Stern who, citing a 1700 pages long contract between UAW and General Motors, express that "several important aspects of this and the other UAW agreements aren't even in the written contracts. According to individuals close to the talks, some of the most sensitive provisions, such as how many jobs the auto makers will actually guarantee, are settled with an "understanding": a handshake or a wink-and-a-nod at the bargaining table." See Blumenstein, Rebecca, and Gabriella Stern, "UAW, Auto Makers Find Some Things Better Left Unsaid," *Wall Street Journal*, November 25, 1996.

The preceding discussion shows that control has different scope and concentration possibilities under different theories. As a result of the different implications of the definition of control under different theories of the firm, allocations of control may not be innocuous towards incentives. The following section will investigate the effects of allocating control to a DIP lender.

#### **IV. Lender Control Scope and Concentration Costs**

So far, an investigation of the consequences of different theories of the firm on particular firm traits has been explored. This section intends to make as explicit as possible the relationship between firm value and allocation of control. As TEB implicitly concedes the existence of value outside the web of explicit contracts, this section of the paper will try to examine what the costs of lender control could be under the other theories of the firm. The main argument to be developed here is that, once the explicit nexus of contracts theory of the firm is discarded due to its stringent assumptions, other externality costs arise when DIP lender is assigned control of the firm, regardless of which other theory of the firm is chosen.<sup>146</sup>

The legal literature has usually relied on the nexus of explicit contracts to think about bankruptcy control concentration costs.<sup>147</sup> An early example of this conceptualization comes from a very insightful paper by Triantis.<sup>148</sup> Triantis focuses

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<sup>146</sup> Again, given that TEB concedes and it is generally agreed that value outside mere explicit contracts exists.

<sup>147</sup> Note that the reliance on the explicit nexus of contracts theory and its main implication, i.e. shareholder value maximization as the corporate objective function, concerns also other fields. As a result, it's been referred as an ideology, which covers additionally goals and expectations. See for example William Lazonick & Mary O'Sullivan "Maximizing Shareholder Value: A New Ideology for Corporate Governance", 29 *Economy and Society* 13 (2000).

<sup>148</sup> See George G. Triantis "A Theory of the Regulation of Debtor-in-Possession Financing", 46 *Vand. L. Rev.* 901 (1993). In the same vein, several other examples can be given. See for example, Barry E. Adler "Financial and Political Theories of American Corporate Bankruptcy", 45 *Stan. L. Rev.* 311

on conflicts of interests<sup>149</sup> between reorganization claimholders produced by priority differences and considers that

“The most enduring problem, however, is that even if successful, the shift in decisionmaking authority to the residual owners does not eliminate financial agency problems. Unsecured creditors are residual owners only at the margin. Their participation in the company's fortunes is bounded on both sides: they share gains with shareholders and losses with the more senior creditors. Therefore, conflicts of interest between the residual owner who holds decisionmaking authority in bankruptcy and these other groups will persist.”<sup>150</sup>

Indeed, exactly this idea is followed by Lopucki's critique of TEB<sup>151</sup> and recent empirical work by Ayotte and Morrison.<sup>152</sup>

As soon as we move away from the nexus of explicit contracts paradigm, other potential costs unfortunately come to share a bankruptcy scene already filled with direct and indirect costs. These costs may vary under each theory and arise out of not only conflicts of interests between claimholders produced by priority differences<sup>153</sup>

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(1993); Lucian A. Bebchuk “Using Options to divide Value in Bankruptcy”, working paper, available at [http://www.law.harvard.edu/programs/olin\\_center/corporate\\_governance/papers/No271.99.Bebchuk.pdf](http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/No271.99.Bebchuk.pdf) (last visited 5/12/07); Oliver Hart, Rafael La Porta, Florencio Lopez-de-Silanes & John Moore “A New Bankruptcy Procedure That Uses Multiple Auctions”, working paper available at <http://ideas.repec.org/p/nbr/nberwo/6278.html> (last visited 07/02/07).

<sup>149</sup> Mehran and Stulz define conflict of interests as “a situation in which a party to a transaction can potentially gain by taking actions that adversely affect its counterparty.” See Hamid Mehran & Rene M. Stulz “The Economics of Conflict of Interests in Financial Institutions”, 85 *Journal of Financial Economics* 267, 268 (2007).

<sup>150</sup> See George G. Triantis “A Theory of the Regulation of Debtor-in-Possession Financing”, 46 *Vand. L. Rev.* 901, 916 (1993).

<sup>151</sup> See Lynn M. Lopucki “The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy”, 56 *Stan. L. Rev.* 645, 660-5 (2003). Nonetheless, Lopucki considers, without explaining how these conceptions interact, that “going-concern value resides principally in relationships”. See Lynn M. Lopucki “The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy”, 56 *Stan. L. Rev.* 645, 652 (2003).

<sup>152</sup> See Keneth M. Ayotte & Edward R. Morrison “Creditor Control and Conflict in Chapter 11”, 1 *The Journal of Legal Analysis* 511 (2009).

<sup>153</sup> For example, Bergström, Eisenberg and Sundgren mention that “Priority differences cause conflicts

but also due to the lack of internalization of implicit contracts value<sup>154</sup> or specific investments by the entrepreneur or key employees. Therefore, I suggest that these costs need to be considered in order to reassess the proclaimed benefits of DIP lender control for economic efficiency, especially since efficiency arguments are the only ones supporting DIP lender control.<sup>155</sup>

Let us revisit the scope and concentration of control under the more novel theories of the firm and their relation to value. As discussed above, the property rights theory of the firm regards control rights in a residual manner. It conceptualizes ownership and control as indifferent, making them inseparable and susceptible to full concentration. The property rights approach ties asset ownership to ex ante incentives that parties have in order to efficiently invest in complementarities. Therefore, value is dependent on physical assets' allocation and

*“ceteris paribus, a party is more likely to own an asset if he or she has an important investment decision”.*<sup>156</sup>

If control is assigned to a DIP lender, the logic of this theory tells us that ex ante incentives will be diminished as the lender would add no complementarities or

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between high and low priority claimholders... Secured creditors who believe they will receive close to full payment in liquidating bankruptcy may prefer bankruptcy over reorganization, even when total payments to creditors would be higher in a reorganization. Secured creditors receive only part of the gain if the value of the reorganized firm increases, but bear all of the costs if the value decreases. Theorists acknowledge the likelihood that secured creditor incentives are skewed towards liquidation over reorganization.” See Clas Bergström, Theodore Eisenberg & Stefan Sundgren “Secured Debt and the Likelihood of Reorganization”, 21 Int’l Rev. L. & Econ. 359, 360 (2002). For a recent empirical study along these lines see Kenneth M. Ayotte & Edward R. Morrison “Creditor Control and Conflict in Chapter 11”, 1 The Journal of Legal Analysis 511 (2009).

<sup>154</sup> Shleifer and Summers advanced this argument in the context of the nexus of implicit and explicit contracts theory of the firm in the context of takeovers. See Andrei Shleifer & Lawrence H. Summers. “Breach of Trust in Hostile Takeovers”, *Corporate Takeovers: Causes and Consequences*, edited by Alan J. Auerbach, pp. 33-56. Chicago: The University of Chicago Press (1988). Below, I will extend the idea to bankruptcy control and to other theories of the firm.

<sup>155</sup> On the proclaimed benefits of DIP lender control, see section I supra.

<sup>156</sup> See Oliver Hart, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE*, Oxford University Press, New York (1995), p. 49.

synergetic value, while he would still share in the proceeds. As a result, assigning control to the DIP lender will hamper specific investments in complementarities by key members of the firm.<sup>157</sup> Having said that, a caveat must be noted: proponents of the efficiency of DIP lender control rely heavily on lenders selling the firm, as they just want to recover what it is owed to them and don't have any special knowledge about the business of running firms.<sup>158</sup> Then, the previous problem would be shoved into the future (though unlikely diminished). The conflict of interests' problem arising from the different priorities enjoyed by different claimants is not affected by the sale of the business line of argument and remains at full strength.<sup>159</sup>

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<sup>157</sup> Aghion and Bolton, in a very famous result in the incomplete contract theory, show that contingent allocation of control to a lender is more efficient than assigning control under any circumstances to either debt or equity. The model in that paper is based on agency costs, which grow when equity value approaches zero because control permits to reap private benefits. The point here is different from Aghion and Bolton, because the analysis doesn't center on agency costs, but follows Grossman and Hart in looking at what other costs may arise when the firm is controlled by someone without the ability of generating complementarities with a specific asset that constitutes the firm. See Phillippe Aghion & Patrick Bolton "An Incomplete Contracts Approach to Financial Contracting", 59 *Review of Economic Studies* 473 (1992). On the same vein, see Jukka Vauhkonen "Financial Contracts and Contingent Control Rights", working paper available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=438501](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=438501) (last visited 6/07/07).

<sup>158</sup> See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 *Stan. L. Rev.* 751, 786 (2002) ("Given the developments in capital markets, such [going-concern] sales are increasingly possible...The market for selling firms as going concerns is well-developed."); Sandeep Dahiya, Kose John, Manju Puri & Gabriel Ramirez "Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence", 69 *Journal of Financial Economics* 259 (2003) (noting that DIP financed firms either reorganize or liquidate (monitoring function) faster than the non DIP financed); Keneth M. Ayotte & Edward R. Morrison "Creditor Control and Conflict in Chapter 11", 1 *The Journal of Legal Analysis* 511 (2009) (when secured creditors are oversecured, they find that cases are significantly shorter and more likely to result in a sale. Also, case speed increases -and the probability of a sale rises- as the claims of oversecured creditors encumber a greater fraction of the firm's assets).

In addition, the use of control by the lender to sell the firm shies away from difference in knowledge that the lender and employees may have into the possible action set. As a result, it doesn't have to deal with any inefficiencies arising out of allocating authority to a lesser informed party. On this issue, see generally Nicolai J. Foss, *STRATEGY, ECONOMIC ORGANIZATION, AND THE KNOWLEDGE ECONOMY*, Oxford University Press, Great Britain (2005), at 126-30; Phillippe Aghion & Jean Tirole "Formal and Real Authority", 105 *The Journal of Political Economy* 1 (1997); Phillippe Aghion, Mathias Dewatripont & Patrick Rey "Transferable Control", 2 *Journal of the European Economic Association* 115 (2004).

<sup>159</sup> This is the main result obtained by Ayotte and Morrison in their recent working paper. See Keneth M. Ayotte & Edward R. Morrison "Creditor Control and Conflict in Chapter 11", 1 *The Journal of Legal Analysis* 511 (2009)

Let's think about the implicit and explicit nexus of contracts theory now. This theory considers that firm value arises out of the web of agreements that constitute the firm. Accordingly, the scope of potential control covers explicit and implicit contractual arrangements but, as we have seen above, control cannot be fully concentrated due to the self-enforcing nature of the implicit contracts (i.e. an informal agreement doesn't provide the parties a transferable right). As there are many informal agreements, assigning control to constituents who, in the case of a sale, do not internalize (impossibility of full concentration) the effect of their decisions on those gaining from the implicit contracts, which generates externality costs and likely affects the value of the firms' hidden assets.

Shleifer and Summers have studied this problem in the context of takeovers, where they affirm that gains in stock price do not entirely reflect efficiency gains, due to the redistribution of wealth from employees (i.e. in terms of lower wages), government (i.e. tax credits) or suppliers to shareholders.<sup>160</sup> Therefore, assigning full control to equity or debt may be inefficient as long as those implicit terms reduce contracting costs and generate efficient incentives. Although, Shleifer and Summers were inspired by the takeover wave of the 1980's, their view seems readily transplantable to bankruptcy, as long as reorganizations are dominated by section 363(b) sales (as believed by professor Skeel, Jr.) and either the DIP or the DIP lender make by himself or together the sale decision.<sup>161</sup>

Finally, let's examine the nexus of specific investment implications of allocating control to the DIP lender. This theory is the first to explicitly address firm

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<sup>160</sup> See Andrei Shleifer & Lawrence H. Summers. "Breach of Trust in Hostile Takeovers", *Corporate Takeovers: Causes and Consequences*, edited by Alan J. Auerbach, pp. 33-56. Chicago: The University of Chicago Press (1988).

<sup>161</sup> See section I and II.A, *supra*.

control as intrinsically dispersed as an important way to generate and tie growth options to the firm. Zingales refers to the dispersed characteristic of control by saying

“The secret [to the creation of firm value] is to create a situation where employees know that their rewards will be greater if they make firm-specific investments. The enterprise does this by giving key employees or units privileged *access* to the enterprise or its critical resources, so that they have power if they specialize.”<sup>162</sup>

The realization that control over critical physical assets is combined with the power over inalienable human assets is an important paradigm shift. What ties the firm together and generates value is the interconnection and complementarities of human and physical resources. The more complementary the growth options are with the resources in place, the more likely it is that they will “belong” to the firm.<sup>163</sup> If a biological analogy is permitted, the nexus of specific investments view of control is morphogenic, because the firm is directed to adaptive structural transformation as a way to maintain and increase its own value.<sup>164</sup>

As mentioned above in section III.A, the nexus of specific investment conceives control’s scope as potentially covering human and non-human assets. Accordingly, the nexus of specific investment implies that complete control concentration is impossible (due to the non-transferability of decision making over human assets). Therefore, DIP lender control is naturally limited by the impossibility of full control concentration. In theory, each person who has made a specific investment would have power to extract part of the benefits (as he is essential to

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<sup>162</sup> See Luigi Zingales “In search for New Foundations”, 55 Journal of Finance 1623, 1646 (2000).

<sup>163</sup> See Luigi Zingales “In search for New Foundations”, 55 Journal of Finance 1623, 1649-50 (2000).

<sup>164</sup> For a view that integrates organization theory, control and biology, see John C. Oliga, POWER, IDEOLOGY AND CONTROL, Plenum Press, New York, NY (1996), at 121-38

obtaining full firm value).<sup>165</sup> As the access to the assets in relation to which specific investments were made is self enforcing (otherwise value is lost to the firm),<sup>166</sup> lack of control concentration would seem to be innocuous. Nonetheless, such a conclusion would be misleading: due to the conflict of interests arising out of priority differences, access is not self-enforceable anymore. As different claim types (except for equity) have a cap on the amount obtainable in bankruptcy equal to what the claimholder is owed, a decision maker with those incentives would not express interest in obtaining full firm value. Naturally, this scheme would translate into fewer amounts spent on specific investments ex ante. As a result, the nexus of specific investment theory tells us that DIP lender control deepens the problem arising out of conflict of interests, which evolve out of priority differences, because value is not only lost ex post (as under the nexus of explicit contracts view) but also ex ante. Then, the allocation of full control/ decision-making power with the DIP lender will likely hamper those valuable investments.

To summarize, TEB recognizes the existence of value besides the web of explicit contracts, therefore conceding that the firm cannot be explained relying merely on that theory. When we look at control concentration possibilities under the other theories it was showed that allocating control to a DIP lender will generate externality costs which the previous literature had not focused on before: diminishing ex ante incentives due to conflict of interests arising out of priority differences, lack of internalization of implicit contracts value or specific investments by the entrepreneur or key employees. Therefore, any claims on the supposed efficiency of DIP lender control need to be reconsidered under the new light generated by these costs. As a

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<sup>165</sup> Raghuram G. Rajan & Luigi Zingales “Power in a Theory of the Firm”, 113 Quarterly Journal of Economics 387, 402-3 (1998).

<sup>166</sup> Raghuram G. Rajan & Luigi Zingales “Power in a Theory of the Firm”, 113 Quarterly Journal of Economics 387, 405 (1998).



corollary, full control concentration has been shown to be infeasible under the rest of the theories explored. Therefore, the mere concept of assigning control to the DIP lender needs to be reconsidered. What amounts to the transferred control? Is it control over physical assets? Is it control over employees with specific investments? Further analysis and research efforts are required in order to provide a plausible answer to these questions.

## **V. Conclusion**

Naturally, creditors possess great incentives to obtain safeguards *ex ante* in their contracts and to pursue the results of those contracts by self-help, court action or negotiation. There's plenty of truth in anticipating that no one else is going to defend them. Courts have not shown much sympathy lately.<sup>167</sup> What's important, though, will be to assess the creditors' ability, incentives and credibility as decision-makers in order to obtain maximum return in exchange for the firm.

This chapter intended to further the understanding of control and value as arising from different conceptualizations of the theory of the firm. In that sense, this chapter followed TEB's methodological footsteps and attempted to go deeper in the investigation of the meaning of the theory of the firm. This chapter has shown that DIP lenders do not internalize the value of the whole firm when we understand the firm to be more than (or different from) just a nexus of explicit contracts. As a result

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<sup>167</sup> In *NACEPF*, the court decided that the recognition of fiduciary duties to creditors in the "zone of insolvency" context may involve: "using the law of fiduciary duty to fill gaps that do not exist." Hence, "the need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners." See *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 Del. LEXIS 227 (Del. May 18, 2007), at 19.

DIP lenders decisions will likely generate costs arising out of: conflicts of interests between claimholders produced by priority differences, lack of internalization of implicit contracts value and specific investments by key employees.

There are several implications arising out of the priority differences, lack of internalization and specific investments. Mainly, the proclaimed efficiency of DIP lender control of the reorganization process must be reassessed taking into account those costs. In addition, the very concept of DIP lender control should further be revised under the light that it cannot be as far reaching as TEB and others have thought.

This introductory chapter also serves to jump start a discussion on several questions which require further investigation and which are analyzed more in depth in the following chapters. In chapter II, I will further explore lender control potential shortcomings, specifically regarding costs arising from creditor control not previously accounted for. Specifically, I will discuss conflict of interests and ex ante investment problems even in a scenario with only one class on legal claimholders. Additionally, I will investigate the effects of lender control on the investment opportunity set of the DIP. I will suggest that lender control problems is not merely a consequence of commonly recognized risk aversion and liquidation bias, but also is connected to relatively poorer adaptation ability,<sup>168</sup> increased ambiguity aversion and less cooperation due to heightened expectations of failures and non-cooperative signal.

In chapter III, I will examine the connection between standard interpretations of what a firm is and the reluctance of courts to impose lender control liability or

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<sup>168</sup> As we'll see below, this leads to an investment scope restriction.

equitable subordination. I will argue that lender control liability theories have fallen in disuse in the United States and this was made possible at least in part by an understanding of the theory of the firm, by legal academics and courts, as a nexus of explicit contracts. A broader understanding of the theory of the firm permits to separate lender control liability results from the so called absolute priority rule. In addition, I will discuss alternative explanations to this reluctance. I will conclude that fraudulent conveyance law cannot be thought of as a functional equivalent, therefore not being able to explain the phenomenon. At the same time, the practice cannot be explained as a result of diverging conduct and liability standards because the agency law safe harbor destroys any ambiguity which would be required for the laws expressive function to have complementarities with the liability standard.

In chapter IV, I will look into possible adjudication problems arising out of cognitive errors when dealing with lender control liability theories. I will suggest that hindsight bias is not the only cognitive bias at play but that we also have to take into account its interaction with the anchoring effect. As a result, a strict liability rule would not be optimal as a way to achieve an efficient level of precautions –risk taking– even in a case of unilateral precautions. A very important consequence of this insight is that lender control liability and director and officer liability cannot be analyzed within a unilateral precaution framework as it has been in the past. Despite this conclusion, the business judgment rule as a no liability rule could still be the best alternative to deal with director and officer liability. Even if this was the case, I will argue none of the reasons supporting a no liability rule in that situation support a no liability rule for lender control liability.

In chapter V, I will use references to the legal development of lender control in the

United Kingdom in order to provide further basis for a proposal to revitalize lender control liability. In addition, I will offer some concluding remarks.

## Lender Control Unexplored Costs

### I. Introduction

As we have seen in the previous chapter, control is one of the most important and commonly used concepts in corporate governance. Nonetheless, the concept has proven impossible to define with any precision.<sup>169</sup> Even operational definitions of control have proven evasive. This difficulty has not stopped researchers from investigating normatively how to best allocate control in firms. Since the extant work of Aghion and Bolton,<sup>170</sup> the finance literature suggests that control should be contingently assigned to creditors in distressed firms as a way to limit agency costs. As a matter of fact, it is quite common to stumble upon the assumption that violation of debt covenants (i.e. non- waived defaults) generates shifts in control in the financial literature.<sup>171</sup> As we have seen, some legal scholars in the United States have recently

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<sup>169</sup> A recent conceptualization of control given by Yair Listokin illustrates the point “Legal rules and standards, such as fiduciary duties or principles of contractual interpretation, seek to fill [contract] gaps, but these rules are imperfect and costly to enforce. Thus, there must be some mechanism for making decisions that are not stipulated by contract. The right to participate in this mechanism is called “control.” See Yair Listokin “The Pivotal Mechanism and Organizational Control”, working paper available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1372822](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1372822) (last checked 04/07/09), page 6. A similar point has been brought up by Emirbayer and Mische when they describe the elusiveness of the concept of agency. See Mustafa Emirbayer & Ann Mische “What is Agency?”, 103 *The American Journal of Sociology* 962, 962 (1998) (“The concept of agency has become a source of increasing strain and confusion in social thought. Variations of action theory, normative theory, and political-institutional analysis defended, attacked, buried, and resuscitated the concept in often contradictory and overlapping ways. At the center of the debate, the term agency has maintained an elusive, albeit resonant, vagueness; it has all too seldom inspired systematic analysis, despite the long list of terms with which it has been associated: selfhood, motivation, will, purposiveness, intentionality, choice, initiative, freedom and creativity.”)

<sup>170</sup> See Phillippe Aghion & Patrick Bolton “An Incomplete Contracts Approach to Financial Contracting”, 59 *Review of Economic Studies* 473 (1992).

<sup>171</sup> See Sudheer Chava & Michael R. Roberts “How Does Financing Impact Investment? The Role of Debt Covenants”, 63 *Journal of Finance* 2085, 2086 (2008) (“However, the instant that the borrower’s net worth falls below this threshold, regardless of the amount, control rights shift to the creditor ...” “...transfer of control rights accompanying a covenant violation leads to a significant decline in investment activity, as creditors intervene in order to thwart inefficient investment or punish managers for perceived misbehavior”). For an exception, see Gary Gorton & James Kahn “The Design of Bank

supported the control shift view, both descriptively and normatively. Baird and Rasmussen,<sup>172</sup> as well as Skeel,<sup>173</sup> have argued that control does indeed shift to creditors in the case of distressed firms and that such shift should be welcomed as it is beneficial from an efficiency standpoint.

This position stands in stark contrast to the recent experience or, to say the least, recent perception in the United Kingdom which led to the adoption of the Enterprise act of 2002. This Act has, for the most part, abolished the administrative receivership, which had drawn concern due to the perceived lack of transparency and accountability,<sup>174</sup> leading to inefficient outcomes. Armour and Mokal have described the administrative receivership as being

“widely regarded as giving an unhealthy amount of power to creditors holding floating charges, who because of their secured status lacked sufficient incentives to rescue failing companies.”<sup>175</sup>

In this chapter, I further consider the implications of allocating control to the main lender in business reorganization cases. Drawing inferences from the literature

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Loan Contracts”, 13 Review of Financial Studies 331, 359 (2000) (“The firm sometimes has an incentive to increase volatility. The outside claimant that is in a position to prevent this, the bank, only imperfectly controls borrower risk-taking”)

<sup>172</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751 (2002). There have been several proposals on privatizations in other areas as, for example, Michael C. Jensen “Active Investors, LBO’s, and the Privatization of Bankruptcy”, 2 Journal of Applied Corporate Finance 35 (1989).

<sup>173</sup> See David A. Skeel, Jr. “Creditors’ Ball: The “New” New Corporate Governance in Chapter 11”, 152 U. Pa. L. Rev. 917 (2003).

<sup>174</sup> Unsecured creditors were viewed as the main constituency suffering from the administrative receivership consequences. See Productivity and Enterprise: Insolvency – A Second Chance, Cm 5234, London, TSO (2001), 9.

<sup>175</sup> See John Armour & Rizwaan J. Mokal “Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002”, Lloyds Maritime and Commercial Law Quarterly 28, 29 (2005). This perception of inefficiency grew despite the existence of the so called ‘London Approach’, where secured creditors wouldn’t press for insolvency under the threat of losing future business. See John Armour & Simon Deakin “Norms in Private Insolvency Procedures: The “London Approach” to the Resolution of Financial Distress”, 1 Journal of Corporate Law Studies 21 (2001)

on the theory of the firm, I uncover the existence of lender control costs beyond conflict of interests due to claimholders with priority differences. The priority differences' cosmology stems from a view of the firm as composed by explicit contracts. Breaking away from that paradigm allows us to identify other sources of lender control costs not tied to priority differences between classes of claimholders. Specifically, I show that even when there is only one class of legal claimholders, lender control may generate suboptimal results due to the suboptimal investment incentives that parties not fully covered by explicit contracts may have.<sup>176</sup> At the same time, the existence of other equal priority claimholders with no firm specific investments may diminish the incentives of lenders in control to extract private benefits through deflating the reorganization value. Finally, I will argue that letting a lender control a reorganization process will likely generate other types of costs related to inefficient restrictions to business plans.

This chapter proceeds as follows. Section II, discusses the explicit nexus of contracts paradigm of the theory of the firm and its implications for lender control evaluations. Section III, presents a simple model to show lender control costs even when there's only one class of legal claimants to the firm assets. Additionally, this section will discuss the possibility of lender control costs arising out of inefficient restrictions to the firm's business plan. Section IV, provides concluding remarks.

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<sup>176</sup> As it will become clear later on, I am not advancing that control shouldn't be contingent on financial structure or financial signals. On the contrary, this shift seems to be an ingenious feature of financial contracting. Rather, I suggest that if control changes in seemingly subverted ways, costs arising from lender control opportunism should be acknowledged and put forward in order to allow the legal system to develop an adequate way of dealing with those costs.

## II. Explicit Nexus of Contracts Permeating into Academic and Court Opinions

Knowing what constitutes a firm is important, in the case of healthy or distressed firms, if nothing else, as a way to understand whether it is beneficial to have a firm running and what works to the benefit or detriment in determining firm efficiency (i.e. allocation of control or governance mechanisms). As we saw in the previous chapter, originally the firm was viewed in terms of the technological transformations a firm was capable of performing,<sup>177</sup> focusing on the maximization of the production function available to the firm.<sup>178</sup> Hence, examinations of difference in return relative to variations in scale were common. Milgrom and Roberts suggest that this “neoclassical theory” merely looked at market failures in competitive environments to find reasons for non-market organizations (i.e. market power, externalities, coordination problems, etc).<sup>179</sup>

The previous chapter also described how later advances replaced this conceptualization by what Zingales refers to as the “explicit nexus of contracts theory”.<sup>180</sup> The explicit nexus of contracts theory is the prevalent view of the firm in corporate finance<sup>181</sup> and was originated in a study by Alchian and Demsetz’s<sup>182</sup> where

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<sup>177</sup> See Sidney G. Winter “On Coase, Competence, and the Corporation”, 4 *Journal of Law, Economics, & Organization* 163, 164 (1988). For an early presentation of the neoclassical viewpoint, see Jacob Viner “Cost Curves and Supply Curves”, 3 *Zeitschrift für National-ökonomie* 23 (1932). Hart considers that “A manager presides over this production set, buying and selling inputs and outputs in a spot market and choosing the plan that maximizes owners' welfare.” See Oliver Hart “An Economist’s Perspective on the Theory of the Firm”, 89 *Colum. L. Rev.* 1757, 1759 (1989).

<sup>178</sup> See Sidney G. Winter “On Coase, Competence, and the Corporation”, 4 *Journal of Law, Economics, & Organization* 163, 164 (1988). Holmstrom and Tirole argue that the theory of the firm in neoclassical terms just asked “what forces ensure that the process will maximize profits”. See Bengt R. Holmstrom & Jean Tirole “The Theory of the Firm”, 1 *Handbook of Industrial Organization* 61, 63 (1989).

<sup>179</sup> See Paul R. Milgrom & John Roberts, *ECONOMICS, ORGANIZATION & MANAGEMENT*, Prentice Hall, Englewood Cliffs, N.J. (1992), at 73-7.

<sup>180</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1630 (2000).

<sup>181</sup> See Luigi Zingales “In search for New Foundations”, 55 *Journal of Finance* 1623, 1630 (2000).

<sup>182</sup> See Armen A. Alchian & Harold Demsetz “Production, Information Costs and economic Organization”, 62 *American Economic Review* 777 (1972).



they modeled a situation in which input from different individuals cannot be verified while output can. As free riding would emerge, their solution involved allowing one person to be focal to the organization by charging her with the duty to monitor the whole venture and pay the other individuals fixed amounts, but also rewarding her with all the residual claims arising from the firm.<sup>183</sup> In this way, the monitor would obtain all the benefits and bear all the consequences from the venue, generating incentives to exert appropriate levels of control. Jensen and Meckling<sup>184</sup> contributed greatly to this approach by describing the firm as a legal fiction tying a set of individually complete contractual relations together.<sup>185</sup> As a result, the firm boundaries' under this theory are set by the costs the monitor incurs in controlling that the agents perform according to the underlying contracts.<sup>186</sup>

As all contracts are assumed to be explicit, the explicit nexus of contracts theory considers that each constituent, except for the shareholders, is fully paid its opportunity cost. Therefore, a firm cannot be worth more than the sum of contracts it unites<sup>187</sup> and shareholders, as only residual claimants, need to be allocated the decision

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<sup>183</sup> See Bengt R. Holmstrom & Jean Tirole "The Theory of the Firm", 1 Handbook of Industrial Organization 61, 67 (1989).

<sup>184</sup> See Michael C. Jensen & William H. Meckling "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 4 Journal of Financial Economics 305 (1976).

<sup>185</sup> See Michael C. Jensen & William H. Meckling "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 Journal of Financial Economics 305, 311 (1976).

<sup>186</sup> Jensen and Meckling define an agency relationship as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent." See Michael C. Jensen & William H. Meckling "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 Journal of Financial Economics 305, 308-11 (1976). Then agency costs are composed of "1. the monitoring expenditures by the principal, 2. the bonding expenditures by the agent, 3. the residual loss." See Michael C. Jensen & William H. Meckling "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 Journal of Financial Economics 305, 322-3 (1976).

<sup>187</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1631 (2000). In Jensen and Meckling words "The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. Although this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other organizations focuses attention on a crucial set of questions—why particular sets of contractual relations arise for

rights.<sup>188</sup> In the same vein, only shareholder interests should be pursued by the firm. As a corollary consequence, in order to value the firm, computing legal claims' prices is both necessary and sufficient.<sup>189</sup>

The explicit nexus of contracts theory is widespread through law academia and court opinions.<sup>190</sup> For example, in the law literature, Easterbrook and Fischel, when they discuss voting, consider that

“The right to vote is the right to make all the decisions not otherwise provided by contract – whether the contract is express or supplied by legal rules”,<sup>191</sup>

This statement implies that residual powers need merely be with the only class possessing residual rights: the shareholders. As for judicial decisions, an example can be observed in the recent opinion *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,<sup>192</sup> where the Chancery Court of Delaware, while considering the existence of duties towards creditors in vicinity of insolvency, expressed that

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various types of organizations, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization. Viewed this way, it makes little or no sense to try to distinguish those things that are “inside” the firm (or any other organization) from those things that are “outside” of it.” See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305, 311 (1976).

<sup>188</sup> Easterbrook and Fischel consider that “As the residual claimants, the shareholders are the group with the appropriate incentives (collective choice problems to one side) to make discretionary decisions... Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.” See Frank H. Easterbrook & Daniel R. Fischel “Voting in Corporate Law”, 26 *Journal of Law and Economics* 395, 403 (1983).

<sup>189</sup> See Michael C. Jensen “Value Maximization, Stakeholder Theory, and the Corporate Objective Function”, 14 *Journal of Applied Corporate Finance* 8, 19 (2001) (“In sum, the appropriate measure for the organization is value creation, the change in the market value of all claims on the firm.”)

<sup>190</sup> Hu and Black call this understanding “the standard contractarian theory of the corporation”. See Henry T. C. Hu & Bernard Black “The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership”, 79 *S. Cal. L. Rev.* 811, 814 (2006).

<sup>191</sup> See Frank H. Easterbrook & Daniel R. Fischel “Voting in Corporate Law”, 26 *Journal of Law and Economics* 395, 402 (1983).

<sup>192</sup> See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, Del. Ch. (2006)

“So long as directors are respectful of the corporation's obligation to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equityholders.”<sup>193</sup>

This means that other constituents besides shareholders must have their full opportunity cost paid.

The explicit nexus of contracts paradigm has generated a standard way of approaching control allocation in distressed firms. Following the works of Jensen and Meckling<sup>194</sup> and Myers<sup>195</sup> allocation of control is associated exclusively to conflict of interests between classes of individuals holding legal claims with different priority levels. Jensen and Meckling's observed that if shareholders of an over-leveraged firm (i.e. debt over asset ratio over 1) are at the helm, they will have incentives to over-invest in high variance projects leaving them to enjoy potential benefits and the creditors to suffer potential losses. Myers' uncovered the underinvestment problem. He described a firm's investment opportunity as call options whose likelihood of being exercised depended on the conflict of interests between debtholders and shareholders. As debtholders had a cap on maximum recovery, if they were at the helm they would tend to disregard opportunities that made them suffer losses in bad scenarios without letting them enjoy the benefits in the good scenarios, regardless of the net present value of the project. Therefore, debtholders' control over investment policy could lead to underinvestment. Empirical studies linking firm characteristics to

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<sup>193</sup> See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174-5 Del. Ch. (2006)

<sup>194</sup> See Michael C. Jensen & William H. Meckling “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, 3 *Journal of Financial Economics* 305 (1976)

<sup>195</sup> See Stewart C. Myers “Determinants of Corporate Borrowings”, 5 *Journal of Financial Economics* 147 (1977). Recently another category has been added to different priority conflict of interests. See Richard Squire “Shareholder Opportunism in a World of Risky Debt” 123 *Harvard Law Review* 1151, 1151-82 (2010)

financial policy decisions suggest the accuracy of those theories' predictions.<sup>196</sup> Aghion and Bolton extended this line of work to show that ex ante efficiency is advanced by allocating control contingent in the financial signals generated by the firm in order to avoid over and under- investment situations.<sup>197</sup>

Relying on some theoretical implications of the explicit nexus of contracts theory, Baird and Rasmussen, as well as Skeel, have praised what they perceive as a new bankruptcy era where control shifts to creditors upon distress.<sup>198</sup> Baird and Rasmussen describe a situation where disputes of control in Chapter 11, which in the previous decade gravitated around the trading of bankruptcy claims, have evolved into an ex ante contingent allocation. They believe that

“Today’s investors allocate control rights among themselves through elaborate and sophisticated contracts that already anticipate financial

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<sup>196</sup> See, generally, Clifford W. Smith & Ross L. Watts “The Investment Opportunity Set and Corporate Financing, Dividend, and Compensation Policies”, 32 *Journal of Financial Economics* 263 (1992).

<sup>197</sup> See Phillippe Aghion & Patrick Bolton “An Incomplete Contracts Approach to Financial Contracting”, 59 *Review of Economic Studies* 473 (1992). Note, that Aghion and Bolton depart from the idea of complete contracts to come to their conclusion. Nonetheless, a central assumption to their model is that “all monetary returns are verifiable, so that the standard incentive schemes considered in the Principal Agent literature are feasible...” See Phillippe Aghion & Patrick Bolton “An Incomplete Contracts Approach to Financial Contracting”, 59 *Review of Economic Studies* 473, 477 (1992)

<sup>198</sup> See Douglas G. Baird & Robert K. Rasmussen “Private Debt and the Missing Lever of Corporate Governance”, 154 *U. Pa. L. Rev.* 1209 (2006); David A. Skeel, Jr. “The Past, Present and Future of Debtor-in-Possession Financing”, 25 *Cardozo L. Rev.* 1905, 1920-1 (2004). Also, see Henry T. C. Hu & Jay L. Westbrook “Abolition of the Corporate Duty to Creditors”, 107 *Colum. L. Rev.* 1321, 1374 (2007) (“Above all, the DIP’s decisions about postpetition financing and the concessions made to lenders to obtain that financing will have a profound effect on all stakeholders.”). The idea of control transfers due to debt covenant violations is widely accepted in the finance literature. See, for example, Sudheer Chava & Michael R. Roberts “How Does Financing Impact Investment? The Role of Debt Covenants”, 63 *Journal of Finance* 2085, 2085 (2008) (“Upon breaching a covenant, control rights shift to the creditor who can use the threat of accelerating the loan to choose their most preferred course of action or to extract concessions from the borrower to choose the borrower’s most preferred course of action”). Before them, F. H. Buckley focused on management displacement to look at the point where control gradually shifts to creditors. See F.H. Buckley “The Termination Decision”, 61 *UMKC* 243, 256 (1992) (“While displacement is often a discrete event, it might also amount to a gradual shift of control to creditors.”)

distress. In the presence of these contracts, a law of corporate reorganizations is largely unnecessary.”<sup>199</sup>

Professor Skeel believes that the new “governance levers have dramatically improved the quality of chapter 11 governance.”<sup>200</sup> Although Baird and Rasmussen consider the possibility that costs may emerge due to DIP lender control of the reorganization firm and process, they suggest that reputation costs, as well as the fear of lender control liability, will serve as limits to lender control opportunistic behavior.

Regardless of the appeal of the explicit nexus of contracts theory’s straightforward logic,<sup>201</sup> several papers have discussed some of its shortcomings. Fama and Miller have pointed out that bondholders are not completely protected from shareholder decision making.<sup>202</sup> Becker points to worker’s specialization to observe that those employees can be affected if the firm fires them before they recoup the investment in specialization and therefore are also residual claimants.<sup>203</sup> In addition,

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<sup>199</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 755 (2002). In the same vein they mention that “When control rights are allocated coherently, no legal intervention is needed to ensure that decisions about the firm’s future are made sensibly. Most large firms now allocate control rights among investors in a way that ensures coherent decisionmaking throughout the firm’s life cycle.” See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 778 (2002). Their view of bankruptcy has received support from several other authors. See, for example, B. Espen Eckbo & Karin S. Thorburn “Economic Effects of Auction Bankruptcy”, working paper, available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=1387347](http://papers.ssm.com/sol3/papers.cfm?abstract_id=1387347) (last visited 06/29/09).

<sup>200</sup> See David A. Skeel, Jr. “Creditors’ Ball: The “New” New Corporate Governance in Chapter 11”, 152 U. Pa. L. Rev. 917, 920 (2003)

<sup>201</sup> In this regard, Jensen notes that “It is logically impossible to maximize in more than one dimension at the same time unless the dimensions are what are known as “monotonic transformations” of one another. Thus, telling a manager to maximize current profits, market share, future growth in profits, and anything else one pleases will leave that manager with no way to make a reasoned decision. In effect, it leaves the manager with *no* objective.” See Michael C. Jensen “Value Maximization, Stakeholder Theory, and the Corporate Objective Function”, 14 Journal of Applied Corporate Finance 8, 10-1 (2001)

<sup>202</sup> See Eugene Fama & Merton H. Miller, THE THEORY OF FINANCE, Dryden Press, Hinsdale, Ill. (1972)

<sup>203</sup> See Margaret M. Blair “Firm-Specific human Capital and Theories of the Firm”, in [Employees and Corporate Governance. Margaret M. Blair and Mark J. Roe, eds., Brookings Institution Press \(1999\)](#), at 60-3, citing Gary S. Becker HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION, National Bureau of Economic Research, New York (1964).

Shleifer and Summers studied efficiency gains of takeovers to conclude that at least in part they arise out of wealth redistribution from stakeholders to shareholders (the redistribution of wealth may come from employees, government or suppliers).<sup>204</sup> As we can see, all these objections point to the fact that even though shareholders are the only *de jure* residual claimants in the nexus of contracts, it doesn't necessarily mean that they are the only *de facto* residual claimants, and likely they are not.<sup>205</sup>

As we've seen before, other theories, such as the explicit and implicit nexus of contracts,<sup>206</sup> the property rights theory of the firm<sup>207</sup> and the nexus specific investment,<sup>208</sup> have been proposed to overcome the problems of the explicit nexus of contracts theory.<sup>209</sup> Despite important differences, all these theories share an important conclusion: the allocation of residual decision rights via ownership can have a significant effect on investments in relationship specific capital (one which has lesser or no value outside the relation for which is created), because it determines to some

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<sup>204</sup> See Andrei Shleifer & Lawrence H. Summers. "Breach of Trust in Hostile Takeovers", in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, Alan J. Auerbach ed., The University of Chicago Press, Chicago (1988), at 33-56. They contended that firms usually rely on implicit contracts which the company must be trusted to respect. To the extent that long term contracts reduce costs, such trustworthiness is a valuable asset to the firm. The need for long term contracts derives from the equal need to promote firm specific investment. The problem is that even if ex ante efficient, in certain states of the world it will be ex post efficient to breach those contracts. Hence, ex post cost breaching needs to be measured against ex ante increase in cost (plus it is more likely to be, at least in part, a redistribution of wealth than anything else).

<sup>205</sup> Milgrom and Roberts suggest that "it may be impossible to identify any individual or group that is the unique residual claimant or, indeed, to identify the benefits and costs accruing to any decision and so compute the residuals." See Paul R. Milgrom & John Roberts, ECONOMICS, ORGANIZATION & MANAGEMENT, Prentice Hall, Englewood Cliffs, N.J. (1992), at 315.

<sup>206</sup> See George Baker, Robert Gibbons & Kevin J. Murphy "Relational Contracts and the Theory of the Firm", 117 Quarterly Journal of Economics 39 (2002).

<sup>207</sup> See Sanford J. Grossman & Oliver D. Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", 94 Journal of Political Economy 691 (1986); Oliver Hart & John Moore "Property Rights and the nature of the Firm", 98 Journal of Political Economy 1119 (1990).

<sup>208</sup> See Raghuram G. Rajan & Luigi Zingales "Power in a Theory of the Firm", 113 Quarterly Journal of Economics 387 (1998); Raghuram G. Rajan & Luigi Zingales "The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms", 116 Quarterly Journal of Economics 805 (2001).

<sup>209</sup> For an enlightening discussion of different theories of the firm, see Erica Gorga & Michael Halberstam "Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge Based Theory of the Firm", 101 Northwestern L. Rev. 1123 (2007).

extent ex post distribution of surplus and therefore will determine the parties' willingness to invest ex ante. For example, Hart mentions the case of GM ownership of Fisher Body, electricity generating plants owning coal mines, and aluminum refinery owning bauxite mines, as cases where allocating ownership to GM, the electrical plant or the aluminum refinery, respectively, generates lesser possibilities of ex post hold-up and consequently more efficient ex ante investment.<sup>210</sup>

These theories of the firm describe a more complex structure than the explicit nexus of contracts paradigm,<sup>211</sup> recognizing the existence of value outside merely saving on transaction costs, important as it is, and focusing on the existence of efficient complementarities. Implicit contracts and the interaction of specific investments are difficult to identify and even more complex to value, but their existence implies that there are hidden assets in an organization.<sup>212</sup> As a result, the mere aggregation of financial claims may not accurately represent the total value of the firm. Further, focusing merely on financial claims to decide what to do with the assets of a distressed firm may be suboptimal because it may disrupt an appropriate asset allocation and control structure.<sup>213</sup> End game situations like bankruptcy maximize the importance of control allocation, as the ability of the economic system to penalize inefficient actions is considerably diminished.

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<sup>210</sup> See Oliver Hart "Firms, Contracts, and Financial Structure", Oxford University Press, New York (1995), p. 29- 33, 50-1. For another clear example, see Patrick Bolton & David S. Scharfstein "Corporate Finance, the Theory of the Firm, and Organizations", 12 Journal of Economic Perspectives 95, 98-9 (1998). Real life examples can be found in Paul A. Joskow "*Vertical Integration* and Long-term Contracts: The Case of Coal-burning Electric Generating Plants", 1 Journal of Law, Economics and Organization 33 (1985).

<sup>211</sup> See George Baker, Robert Gibbons & Kevin J. Murphy "Relational Contracts and the Theory of the Firm", 117 Quarterly Journal of Economics 39, 70-1 (2002).

<sup>212</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1635 (2000).

<sup>213</sup> See George Baker, Robert Gibbons & Kevin J. Murphy "Relational Contracts and the Theory of the Firm", 117 Quarterly Journal of Economics 39, 41 (2002).

The preceding discussion suggests that control allocation may not be innocuous towards incentives beyond mere balancing of agency costs of different set of claimants. The next section will look at control allocation costs abandoning the explicit nexus of contracts paradigm and will show the existence of other costs that need to be taken into account before advancing a definite judgment on the desirability of lender control. Specifically, the next section will show that allocation costs occur even when only one class of legally recognized claims exist.

### **III. Single class of claimants and lender control costs**

In this section, I intend to specifically tie the notions of lender control and the theory of the firm in bankruptcy. I present a stylized model drawing from previous work by Hart,<sup>214</sup> to illustrate inefficiencies that may arise in reorganization under lender control. The existence of more than one class of legal claimants has been shown to be the source of inefficiencies in bankruptcy.<sup>215</sup> The focus of this section is different from previous work on the matter because it focuses on lender control costs where there is only one class of legal claimants, a situation which could resemble a reorganization case where a controlling lender has all the assets encumbered whose value is smaller than what is owed to that lender. Hence, I will show that assignment of property rights in reorganization is not irrelevant, under certain conditions, to the value of a firm and that its effects have been overlooked by authors defending the idea of lender control of reorganizations.

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<sup>214</sup> See Oliver D. Hart “Incomplete Contracts and the Theory of the Firm”, 4 Journal of Law, Economics and Organization 119, 125-7 (1988).

<sup>215</sup> The problem is closely related to what Hansmann and Kraakman call “liquidation protection” when discussing affirmative asset partitioning. See Henry Hasmann & Reinier Kraakman “The Essential Role of Organizational Law”, 110 Yale L.J. 387, 403 (2000) (“That threat lies principally in the possibility that partial or complete liquidation of the firm's assets could destroy some or all of the firm's going concern value, with the result that, even if the firm were to remain solvent after a partial liquidation, the net value left to the firm's owners, and available as security for the firm's creditors, might well be reduced”).



### **A. A Simple Example**

A simple example, inspired on a real Louisiana lender liability case, will help to motivate the problem.<sup>216</sup> Suppose that there's a farm adjacent to a large river bed and close to some hills. Fluctuations in rain upstream generate occasional flooding problems. Additionally, precipitation concentrations on the nearby hills also generate flooding because the basin of the creek which carries water into the river can't hold large amounts of water. As a result, the farm is better apt for beef cattle ranching (an activity which allows for great flexibility) and the owner decides to focus on the cow/calf business, which basically involves having a herd of cows and some bulls and breeding them from year to year. Unfortunately, cattle- ranching can present several difficulties and this farm has some that are specific to it.

Let's assume that the owner of the farm enters into a contract with a service provider (SP) to manage the cattle (meaning that the farm owner will provide the land and the animals, while SP will need to take care of the cattle breeding and growing the cattle). Let's assume also that SP will get as compensation a fixed percentage of the net profit made by the farm in its cattle ranching business. In order to be effective, SP needs to invest in acquiring knowledge specific to the farm. SP will need to learn among other things the type of grass growing in different sections of the farm as well as whether the cattle likes it or not, how resistant to weight the terrain is (i.e. will the cattle have difficulty moving through a terrain flooded with a foot of water?), how fast does the water drain when there is flood, whether smaller animals adapt better to one part of the farm relative to others, etc. Much of what SP needs to learn could be potentially applied to other farms, such as the incidence of rain a couple of hundred

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<sup>216</sup> See *Benton Johnson v First National Bank of Shreveport*, 792 So. 2d 33 (La. App. 3 Circuit, 2001).

miles upstream, but an important amount is specific to this particular farm (i.e. how fast does the creek water drain). Then, the amount of time and effort that SP will decide to invest in learning about his job will be determined by his ability to earn from it later and the firm's profitability.

As with any other investor, in order to decide how much to invest, SP will have to look at the return prospects of his investment. The later will be determined partly by the ability of the owner to decide on issues which were non- bargained for.<sup>217</sup> If, for example, SP believes that the owner of the farm may decide to extract private monetary benefits and that such extraction can't be prevented, the total amount of firm net earnings will be reduced and so will his profit share.<sup>218</sup> For instance, the owner could assign to himself a salary (i.e. arising out of monitoring like functions) well beyond market value or spend the farm's business money in perks only enjoyable by him.<sup>219</sup> As the amount of net profits will be diminished by the amount of private benefits, then SP's incentive to invest in learning about the farm will diminish. In the extreme, the rent seeking behavior could lead to a termination of the business relation with SP, leaving SP unable to reap the benefits of his specific investments.

The problem of non- bargained for rent extraction can be partially dealt with by adjusting different governance and contractual levers. As firms become distressed,

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<sup>217</sup> This is an assumption which represents the incomplete nature of contracts.

<sup>218</sup> Note the extraction of private benefits does not equate fraudulent behavior and it could more closely be described as something akin to "underhanded practices". See Michael Gorr "Liberalism and the Paradox of Blackmail", 21 Philosophy and Public Affairs 43, 47 (1992).

<sup>219</sup> A very large stream of literature has studied private benefits of control and their effects on firm value. See, for example, Alexander Dyck & Luigi Zingales "Private Benefits of Control: an International Comparison", 59 Journal of Finance 537 (2004); Lucian A. Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control. National Bureau of Economic Research Working Paper No. 7203, Jul. 1999, available at [www.nber.org/papers/w7203](http://www.nber.org/papers/w7203) (last checked 09/04/09). For a description of possible ways of extracting rents in the Law literature, see Nina A. Mendelson "A Control-Based Approach to Shareholder Liability", 102 Colum. L. Rev. 1203 (2002).

the bankruptcy rules become central to the prevention of rent seeking behavior which could reduce further the incentives for SP not to invest ex ante. Suppose that there's a positive probability that after SP's investment a sudden change in relative prices will lead the farm into Chapter 11 reorganization while all of the farm's assets are encumbered (as a way to obtain working capital). If the bankruptcy rules allow or even favor control shifts in order to obtain debtor-in-possession (DIP) financing, then the controlling lender (LC) may be able to shift the business focus into a different scenario where SP's specific investment is not valuable anymore (regardless of what is the more valuable business solution) or to increase his ability to reap private benefits. For example, LC may decide to change the business plan from cattle ranching into a cow-calf business where SP's acquired knowledge is less valuable, or even worthless. As a result, SP's incentive to invest ex ante will be smaller under such a bankruptcy rule. Therefore, and even though there could realistically be only one legal claimant, LC, the outcome of chapter 11 could be determined by the allocation of reorganization control.

### **B. A stylized model**

This section illustrates a stylized version of chapter 11 reorganization case where, as Baird and Rasmussen and Skeel have discussed, a lender is in control of the bankrupt debtor<sup>220</sup> and, as a result, in control of the proceedings also.<sup>221</sup> Unlike general chapter 11 proceedings, I assume that there is only one class of legal claimants, the lender in control (LC) who owns all the debt claims to the firm, and another party, an independent SP, who has the ability to make relationship specific

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<sup>220</sup> See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 Stan. L. Rev. 751 (2002); David A. Skeel, Jr. "Creditors' Ball: The "New" New Corporate Governance in Chapter 11", 152 U. Pa. L. Rev. 917 (2003).

<sup>221</sup> See Lucian A. Bebchuk & Howard F. Chang "Bargaining and the division of value in Corporate Reorganization", 8 Journal of Law, Economics and Organization 253 (1992)

investments. The existence of only one source of legal claimants could be interpreted as a situation where a firm is so heavily indebted that there is not any plausible scenario under which the lender could be fully paid. Alternatively, it could be understood as a situation where one person provided all the financing to the firm, as a result being the only equity and debt holder for a business, which due to a potent financial shock is currently worth a lot less than the face value of debt.<sup>222</sup> It is important to note that SP is not an employee of the debtor and therefore will not generate a claim to salary under the model. This feature of the model is not essential, but serves the purpose of highlighting the existence of control related costs where there's only one class of legal claimants.<sup>223</sup>

At the outset of the model, I am denying the possibility that controlling lenders can make any relationship specific investments. Although I acknowledge that this is a very strong assumption, there are reasons to believe that this assumption is closely related to current lending practices. At least in the US, lenders' focus seem to be on assessing the viability of possible investments and in monitoring those investments.<sup>224</sup> This specialization in monitoring is established by lenders' extensive experience on the matter.<sup>225</sup> At the same time, lenders' lack of specific knowledge about other type

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<sup>222</sup> Notice that this interpretation doesn't necessarily mean that the business was originally undercapitalized. It is conceivable that a financially healthy business from the onset may become bankrupt after losses and/or a financial shock, as the concomitant financial crisis demonstrates.

<sup>223</sup> In fact, very little would change if SP was an employee with a fixed salary. This presentation is admittedly extreme, in the sense that no part of the relationship between LC and SP is subject to an explicit contract at date 1.

<sup>224</sup> See Dianna Preece & Donald J. Mullineaux "Monitoring, Loan Renegotiability, and Firm Value: The Role of Lending Syndicates", 20 *Journal of Banking & Finance* 577, 578 (1996) ("The prevalent interpretation in the literature is that financial intermediaries provide specialized monitoring, screening, and certification services to borrowers"). See also Douglas W. Diamond "Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt", 99 *Journal of Political Economy* 689 (1991)

<sup>225</sup> For instance, Roberts and Sufi show that lenders monitor their borrowers as more than one quarter of publicly listed firms in the US in the period between 1996 and 2005 report that they violated a financial covenant at least once. See Michael R. Roberts & Amar Sufi "Control Rights and Capital Structure: An Empirical Investigation", Michael R. Roberts & Amar Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 64 *The Journal of Finance* 1657 (2009).

of business' aspects (i.e. day to day running of the firm) is hinted at by Mann who obtained extensive anecdotal information showing that lenders prefer to leave assets with debtors under the expectation of higher recovery rates than if they get involved.<sup>226</sup> In addition, and depending on the health of the business –as a proxy for access to finance–, asset tangibility may overshadow any other type of general business monitoring by lenders, which makes the null specific investment assumption by LC even more plausible.<sup>227</sup>

Let's further assume that the debtor firm has only one asset which produces a profit. Alternatively, all the assets of the firm can be thought as a unity where the ability to work with them is either given or not. This bankruptcy reorganization model has two periods, 1 and 2. In period 1, SP chooses an action  $e$  representing relationship specific investment which generates a total return at date 2 equal to the value of the firm  $V(e)$ . SP's action cannot be observed by any other person and makes him incur a private cost equal to  $e$ .<sup>228</sup> In the case that SP does invest ( $e=0$ ) then at period 2 firm value is  $V(0)$ .<sup>229</sup> The previous depiction of the reorganization time frame is entirely plausible given the reported length of US chapter 11 proceedings. For example, Carapeto found the length of the proceedings for firms reorganizing after the proposal

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<sup>226</sup> See Ronald J. Mann "Strategy and Force in the Liquidation of Secured Debt", 96 Mich. L. Rev. 159, 178 (1997) ("When questioned about their reticence to repossess collateral, the account executives uniformly pointed to the general success of allowing the debtor to sell the collateral: the executives ordinarily expect to get full repayment if they leave collateral in the debtor's possession and rarely expect to get full repayment if they do not. Surprisingly, that perception seems to be well justified."). This may have recently changed for high tech start-ups. See R. Mann "An Empirical Investigation of Liquidation Choices Failed High Tech Firms", 82 Wash. U. L. Q. 1375 (2004).

<sup>227</sup> See Heitor Almeida & Murillo Campello "Financial Constraints, Asset Tangibility and Corporate Investment", 20 Review of Financial Studies 1429 (2007) (they show a "nonmonotonic effect of tangibility on cash flow sensitivities: at low levels of tangibility, the sensitivity of investment to cash flow increases with asset tangibility, but this effect disappears at high levels of tangibility"); and, Diemo Dietrich "Asset Tangibility and Capital Allocation", 13 Journal of Corporate Finance 995 (2007).

<sup>228</sup> It is assumed that SP does not have any financial constraints which would force him to invest a level of  $e$  inferior to his first best option.

<sup>229</sup> When  $e=0$ , LC and SP do not enter into an agreement in date 2 and LC obtains the 100% of  $V(0)$ .

of the first plan to be on average 272 days, while for firms where more than one plan was proposed the average length was 524 days.<sup>230</sup> To keep things as simple as possible, it is assumed that  $V(e)$  is deterministic, twice differentiable and strictly concave.<sup>231</sup>

Following Grossman and Hart,<sup>232</sup> there is an action involving the asset which can be taken at date 2 but cannot be specified in the contract at date 1. This generates contractual incompleteness, in turn making residual control rights relevant as whoever is in control will be able to obtain a share of any possible benefits arising out of a consensual transaction.<sup>233</sup> To show this contractual incompleteness, it is assumed that whoever is in control always obtains a non-verifiable fraction  $(1-\alpha)$  of  $V(e)$  of the total proceeds or total cash flows, where  $0 < \alpha < 1$ . This fraction of firm value may be interpreted as if the controlling lender presents a reorganization plan where the value of the firm is underscored, so that he can obtain a larger portion of resulting business' equity. Indeed,  $(1-\alpha)$  speaks about one of the most significant problems in bankruptcy, determining firm value, one that the United States reorganization scheme was purposely designed to sidestep.<sup>234</sup> Alternatively, it could represent above market value prices for services rendered by the controlling lender or any other type of tunneling.<sup>235</sup>

<sup>230</sup> See Maria Carapeto "Is Bargaining in Chapter 11 Costly?", Cass Business School Working Paper, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=241569](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=241569) (last visited, 06/20/10). This figure is consistent with the findings in other studies. See, for example, Kenneth M. Ayotte & Edward R. Morrison "Creditor Control and Conflict in Chapter 11", 1 The Journal of Legal Analysis 511 (2009) (reporting that firms stay in bankruptcy an average of 15 months)

<sup>231</sup> Ergo,  $V'(e) > 0$  and  $V''(e) < 0$ .

<sup>232</sup> See Sanford J. Grossman & Oliver D. Hart "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", 94 Journal of Political Economy 691, 696 (1986) ("We have in mind a situation in which it is prohibitively difficult to think about and describe unambiguously in advance how all the potentially relevant aspects of the production allocation should be chosen as a function of the many states of the world").

<sup>233</sup> In the same way as in the previous section example.

<sup>234</sup> One of the principal innovations of the Bankruptcy Code was to use voting in Chapter 11 in order to avoid the need for the court to perform cumbersome valuations.

<sup>235</sup> For a description of tunneling practices as well as for some non-US court opinions on the matter, see Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer "Tunneling", 90 AEA Papers and Proceedings 22 (2000).

The remaining share  $\alpha V(e)$  is verifiable, and therefore contractible upon in the first period. It is clear then that a contract between LC and SP can only consist of a division of the firm's verifiable return or profits,  $\pi = \alpha V(e)$ . As only  $\pi$  is verifiable, SP's reward upon providing his services depends on  $\pi$  and is represented by the fraction  $\beta\pi$ , where  $0 < \beta \leq 1$ .  $\beta\pi$  is the rule the parties adopt in period 1 to divide any profits arising out of their joint venture in period 2.

In order to maximize social efficiency  $\Pi$  and regardless of who is in control, the investment should work to maximize  $\Pi = V(e) - e$ . Therefore, social efficiency will be obtained when

$$V'(e) = 1 \quad (1)$$

Introducing control as a relevant factor modifies the incentive structure.<sup>236</sup> If, as in the framework of this paper, LC controls the firm, SP settles at date 1 for a level of  $e$  knowing that LC will obtain at least the fraction of value  $(1 - \alpha)V(e)$  and maybe more depending on how large  $\beta$  is, SP's bargaining power. Therefore, SP will invest at period 1 so as to maximize his private benefit  $\beta\alpha V(e) - e$ . It follows that because  $\alpha < 1$  (showing the non-contractible fraction) and  $\beta \leq 1$ , SP will not capture the full value deriving from his effort as his maximization function will be

$$\beta\alpha V'(e) = 1 \quad (2)$$

which is smaller than (1).<sup>237</sup>

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<sup>236</sup> Williamson believes that control discussions cannot be assumed away and that therefore "the supply of a good or service and its governance need to be examined simultaneously". See Oliver E. Williamson "Corporate Finance and Corporate Governance", 43 Journal of Finance 567, 567 (1988).

<sup>237</sup> Recall that  $V(e)$  is by assumption twice differentiable and strictly concave.

Alternatively, in the case where SP controls the firm,<sup>238</sup> he will invest in order to maximize both his verifiable  $\beta\alpha V(e)-e$  plus his non-verifiable share  $(1-\alpha)V(e)$ , which would turn to be

$$\beta\alpha V'(e)+(1-\alpha)V'(e)=1 \quad (3)$$

which confirms the intuition that SP's investment decision will be closer to the socially optimal (perhaps even equal to the socially optimal if  $\beta=1$ ) when he doesn't have to share unverifiable parts with LC.<sup>239</sup> Only when SP controls the firm's asset the investment level can approximate the first-best. The bigger the size of  $\beta$  the closer the investment level will be to the optimal one.

This simple model shows that, under conditions of contractual incompleteness and relationship specific investments allowing for value diversion, the value of a firm may be heavily dependent on control allocation. In fact, Hart states that giving the party capable of making a value enhancing relationship specific investment "entitlement to the asset's profit stream will not be enough [to achieve a first best] since an outside owner may be able to divert some of the asset's return for his own uses, thus dulling the manager's incentives."<sup>240</sup> In the same spirit, Blair and Stout state, while discussing the importance of legal personality of corporations, that

"Specific investment is discouraged when individual investors have a legal right to prematurely withdraw their contributions (and with it, the ability to opportunistically threaten to withdraw in order to "hold up"

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<sup>238</sup> Ergo, SP doesn't need to share with LC  $(1-\beta)\alpha V(e)$  either

<sup>239</sup> This follows from the assumption that  $V(e)$  is twice differentiable and strictly concave which means that  $V(e)$  will have a larger value than  $\alpha V(e)$  for any value of  $e$ .

<sup>240</sup> See Oliver D. Hart "Incomplete Contracts and the Theory of the Firm", 4 Journal of Law, Economics and Organization 119, 127 (1988).



their fellow investors in an attempt to extract a larger share of the surplus generated by corporate activity).”<sup>241</sup>

### **C. Relaxing the restriction on the number of claimholders**

In the previous section, a very restricted model was presented where there was only one legal claimholder, namely LC. In this section, this assumption of the basic model will be dropped to allow for the introduction of more than one class of claimholder and, alternatively, more than one claimholder. The analysis to be presented below won’t focus on the negotiation effects of having more than one claimholder on ex ante investments, but it will be followed by a succinct discussion of those issues.

When LC is not the only class of claimholder (i.e. where there is a class of equityholders and/or junior creditors), which is usually the case in corporate reorganization proceedings, his ability to obtain verifiable profits will have a cap (C) given by the dollar amount of his claim. In other words, LC will be able to extract in verifiable profits

$$\min (C; (1-\beta)\alpha V(e))$$

The difference between  $(1-\beta)\alpha V(e)$  and C, if positive, would be allocated not to SP but to the other claimholders. In principle, and as expected, this wouldn’t affect SP’s incentives to invest under either control scenario and would suggest that having more than one claimholder implicates the same results.<sup>242</sup>

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<sup>241</sup> See Margaret M. Blair & Lynn A. Stout “Specific Investment: Explaining Anomalies in Corporate Law”, 31 Iowa J. Corp. L. 719, 730 (2006)

<sup>242</sup> In this point, I am assuming that SP will have priority over the share of other bankruptcy claimants. This assumption follows from the priority that §507(a)(2) of the Bankruptcy Code allows for administrative expenses, which include SP’s post-filing services which are expenses incurred in the general operation of the business.

It may be the case, nonetheless, that the effect on the non-verifiable share of value which LC may be able to extract will depend on how that non-verifiable value can be diverted, possibly acting as a cap there also. Baird and Rasmussen<sup>243</sup> have advanced that LC's abuses will be limited because of the existence of lender control liability theories. Even though I will argue in the next chapter that such view is at odds with the application of lender control liability theories by courts, lender control liability, if revitalized, may still have an effect on how rent is extracted in egregious cases. Namely, lender control liability theories may limit rent extraction through underscoring the value of the reorganizing entity.

Let's see why. If LC diverts profits to himself merely by underscoring the value of the reorganizing firm, then his profit diversion capacity may also be indirectly capped. As by assumption  $\alpha V(e)$  is verifiable, then claiming that the firm is valued at  $U$ , where  $U < \alpha V(e)$  will have a higher risk of lender control liability finding<sup>244</sup> Therefore, LC will have incentives induced by the legal system not to underscore the value of the firm in a reorganization proposal below  $\alpha V(e)$ . Now, LC's cap may be bigger than  $\alpha V(e)$ , in which case LC's priority up to  $C$  will protect him, or it may be smaller. Even if it is smaller, LC's incentives may not be modified because SP's share,  $\beta \alpha V(e)$ , needs to be guaranteed in order to get SP to contribute his service to the firm.<sup>245</sup> When the share of the total verifiable profits  $(1-\beta)\alpha V(e)$  is larger than  $C$ , then LC's incentives to extract unverifiable benefits through deflating the reorganization value would be trumped as the other claimant would still get a share

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<sup>243</sup> See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 Stan. L. Rev. 751, 777-785 (2002) (discussing strategies taken by lenders which include "recommending" the debtor to hire a turnaround professional or imposing short term financing).

<sup>244</sup> Alternatively, LC will risk that his plan won't pass the bankruptcy judge mustard or that the proposed section 363 sale won't be approved. A discussion of acceptable value ranges can be found below in section IV of chapter III.

<sup>245</sup> As I mentioned in a footnote above, SP's contribution is assured by §507(a)(2) of the Bankruptcy Code.

$$\frac{[(1-\alpha)V(e)] * \frac{C}{(1-\beta)\alpha V(e)}}{C}$$

of the reorganized firm (because  $\frac{C}{(1-\beta)\alpha V(e)}$  is the maximum percentage of stock assignable to LC under a reorganization plan).

Deflating the reorganization value may not be the only way that LC has to divert value to himself, as it has been pointed that whoever controls the firm may have an advantage in designing the reorganization plan.<sup>246</sup> Then, the relative importance of the cap on a controlling lender is apparent. For example, for corporate bankruptcies filed in the second part of 2001, Ayotte and Morrison report that ratio of secured debt to assets in the filing schedules was 0.65.<sup>247</sup> This figure likely represents a higher bound on the ratio as there is a significant drop in the value of the assets reported in the last 10-K relative to the figure reported in the bankruptcy schedules.<sup>248</sup>

As a result, we find that having more than one class of claimants may actually be a good thing to prevent value diversion through undervaluing the assets of a distressed firm, because the other claimants will be able to extract part of the private benefits in the case where  $C$  is smaller than  $(1-\beta)\alpha V(e)$ . This result suggests that LC's incentive to reorganize won't necessarily grow as a result of gaining control.

Unfortunately, even if LC has a cap on the amount of value that he can divert due to the existence of other claimholders, the effects are not necessarily beneficial to SP or more generally any party making relationship specific investments (unless the intersection of the set of relationship specific investors and the set of other

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<sup>246</sup> See generally See Lucian A. Bebchuk & Howard F. Chang "Bargaining and the division of value in Corporate Reorganization", 8 Journal of Law, Economics and Organization 253 (1992)

<sup>247</sup> See Kenneth M. Ayotte & Edward R. Morrison "Creditor Control and Conflict in Chapter 11", 1 The Journal of Legal Analysis 511 (2009).

<sup>248</sup> The mean value of assets reported in the last 10-K in their sample was 122.81 millions, while the median value of the assets reported in the bankruptcy schedules was 37.34 millions.

claimholders is non empty). Further, the existence of other classes of claimholders may be prejudicial to SP as it makes some reorganization strategies less attractive to LC as his benefits from reorganization are reduced. In addition, making some reorganization strategies less appealing to LC boosts his bargaining position, which will be translated in smaller  $\beta$  in the case that the firm actually reorganizes and a correlative smaller SP ex ante investment as he will be able to obtain less.

Note that LC's incentive to extract private benefits in reorganization through undervaluing the assets would be largely diminished if the other claimholders share equal priority. When LC is not the only claimholder and the other claimholders share equal priority, his ability to recoup both verifiable and non-verifiable profits will be determined by the ratio of his claim  $C$  to total debt ( $D$ ). Therefore, LC will be able to obtain verifiable profits equal to  $(C/D) \cdot (1-\beta) \alpha V(e)$ . It follows from the extraction of private benefits rule that we are using that only  $(C/D) \cdot (1-\alpha) V(e)$  of the non-verifiable profits will be obtained by LC, while the rest would be captured by its equal priority claimholder. Paradoxically, unless  $D$  is smaller than  $(1-\beta) \alpha V(e)$ , having equal priority among creditors would, *ceteris paribus*, generate more liquidations than reorganizations because the amount of private benefits to be extracted.

Naturally, claiming a lower value for reorganization assets is not the only way of reaping non-verifiable benefits. Some other ways of reaping those benefits will not be shared by other claimholders and may then be preferable to LC. Nonetheless, this specific form of extracting value is still available even when decision management and decision control are separated, as it is at least formally the case in Chapter 11.<sup>249</sup>

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<sup>249</sup> Fama and Jensen consider that an organization decision process consists on decision management (involving the initiation and implementation decisions) and decision control (focused on ratification and monitoring decisions). See Eugene F. Fama & Michel C. Jensen "Separation of Ownership and Control", 26 Journal of Law and Economics 301 (1983).

Hence, this form of rent extraction is indeed important to LC.

#### **D. Inefficient restrictions to business plans**

Start-up firms financed by venture capital firms (VC) have often been related to distressed firms, because in both cases the investors have to deal with robust conflict of interests.<sup>250</sup> According to Kaplan, Sensoy and Stromberg it is possible and likely that VC firms place implicit constraints in business plan modifications<sup>251</sup> because they invested their money in a certain business plan.<sup>252</sup> These constraints show a sharp contrast with the evidence on adaptation obtained by Bhidé on other start-ups lacking VC funding.<sup>253</sup> Bhidé discusses several cases of entrepreneurs who started successful businesses without a detailed business plan at all and little funds. In the case of these entrepreneurs, the success of their ventures depends heavily on opportunistic adaptation, rather than merely following ex ante ideas. As a result, it appears that VC firms in their attempt to limit conflict of interests also restrict the set of growth opportunities.

It seems quite reasonable that the same scenario appears with lender control of a Chapter 11 proceeding.<sup>254</sup> Conditional on the conjecture of similarity between

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<sup>250</sup> See Steven N. Kaplan & Per Strömberg “Financial Contracting Meets the Real World: An Empirical Analysis of Venture Capital Contracts”, 70 *Review of Financial Studies* 281, (2003).

<sup>251</sup> See Steven N. Kaplan, Berk A. Sensoy & Per Stromberg “What Are Firms? Evolution from Birth to Public Companies”, working paper available at <http://www.nber.org/papers/w11581.pdf> (last visited 1/29/2008), at 28-30 (“While the companies grow dramatically, their core businesses remain remarkably stable. Within core businesses, firm activities tend to stay the same or broaden over time.”)

<sup>252</sup> Referring to corporations (as banks or lenders in general) preference towards investments, Bhidé states “The nature of the evidence required by corporate decision-makers leads them to favor initiatives where the risks and returns can be objectively assessed.” See Amar V. Bhidé, *THE ORIGIN AND EVOLUTION OF NEW BUSINESS*, Oxford University Press, New York, NY (2000), at 120

<sup>253</sup> See Amar V. Bhidé, *THE ORIGIN AND EVOLUTION OF NEW BUSINESS*, Oxford University Press, New York, NY (2000), at 53-68.

<sup>254</sup> A similar assumption is made by Lofthofer and Peters. See Stanley D. Longhofer & Stephen R. Peters “Protection for Whom? Creditor Conflict and Bankruptcy”, 6 *American Law & Economics Review* 249, 274 (2004) (“By limiting the firm’s ability to misuse the assets, the creditor may also hamper the firm’s ability to redirect these assets to their highest valued use.”)

distressed financing and start-ups financing which even TEB makes,<sup>255</sup> the high degree of constraints imposed by controlling lenders of distressed firms on the latter business plan, be it in changes or adaptations, limits the ability of distressed firms to gain on unexpected opportunities.<sup>256</sup> This conjecture is quite plausible, as Williamson considers that uncertainty, which makes great use of adaptation, tends to hurt more debt financed projects (those based strictly on rules) than equity financed ones and as a result “greater use of equity finance is favored, *ceteris paribus*”.<sup>257</sup> The fundamental reason behind the adaptation ability difference is the relatively poorer ability of a controlling lender to attribute unexpected events to the right causes due in large part to the lack of expertise in the particular venture.<sup>258</sup>

Noticing investment adaptation restrictions arising from the financial structure of the firm are important at least for two reasons. First, the explicit nexus of contracts paradigm focuses entirely on agency costs and, as the agency costs of distress grow, changing management becomes one of the most pressing needs. Then, the problems of adaptation ability tend to be overlooked in favor of focusing on agency costs.<sup>259</sup>

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<sup>255</sup> TEB links start ups to distressed firms through the proposal of and/or support for an equivalent contingent contractual allocation of control, using as an example the case of Webvan (which coincidentally was both a start up and a distressed firm. See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 780-5 (2002).

<sup>256</sup> On an early empirical account on the constraints imposed by lenders, see Stuart C. Gilson “Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control when Firms Default”, 27 Journal of Financial Economics 355, 365-8 (1990) (finding that banks restrict the allowable outlay on general and administrative expenses (25% of the sample), permitted investments (22.5%), and capital expenditures (30%)).

<sup>257</sup> See Oliver E. Williamson “Corporate Finance and Corporate Governance”, 43 Journal of Finance 567, 584 (1988) (emphasis in original) (“added uncertainty pushes the firm into a maladapted state more often and/or more consequentially”). Uncertainty is used here in a Knightian sense and is understood to arise “from the impossibility of exhaustive classification of states.” See Richard N. Langlois & Metin M. Cosgel “Frank Knight on Risk, Uncertainty, and the Firm: A new Interpretation”, 31 Economic Inquiry 456, 459 (1993).

<sup>258</sup> Bhidé considers that the capacity for adaptation depends on the entrepreneurs decisiveness, open-mindedness, managing internal conflict and attribution skills. See Amar V. Bhidé, *THE ORIGIN AND EVOLUTION OF NEW BUSINESS*, Oxford University Press, New York, NY (2000), at 99-104.

<sup>259</sup> A notable exception is Buckley, who discusses the adaptation ability of new managers as an important factor: “Termination might also be valuable because of the specialized skills required to manage a firm in financial distress. Managers might be required to think creatively of alternative uses

Second, the investment scope restriction is separate and complementary to the investment magnitude restriction typically imposed by lenders when firms' performance is poor and discussed at large by the literature.<sup>260</sup> It is unclear what the conjunct effect of these restrictions turns out to be.

The effect of the adaptation ability difference won't be constant<sup>261</sup> and will most likely be influenced by the specialization of the lending firm and of the specific default unit managers which in turn have been found to influence financial firm involvement. For instance, in the context of European start-ups, Botazzi, Da Rin & Hellman find that "an active investment style is strongly related to a financial intermediary's organizational specialization. Independent venture capital firms [firms that only engage in venture capital deals and firms which concentrate on relatively few deals per partner] are significantly more likely to get involved with their

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for firm assets, and to deal persuasively with claimholders in a reorganization. These tasks might require the skills of "vulture capitalists," rather than those of incumbent managers, whose expertise is rooted in the firm's current operations. In addition, creditors might specialize in the alternative uses to which firm assets may be put." See F.H. Buckley "The Termination Decision", 61 UMKC 243, 250 (1992). What Buckley doesn't share with us is why banks are better able to hire "vulture capitalists" and how does their specialization on finding alternative uses helps these "vulture capitalists" rather than constrain them.

<sup>260</sup> See Greg Nini, David C. Smith & Amir Sufi "Creditor Control Rights and Firm Investment Policy", working paper available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=928688](http://papers.ssm.com/sol3/papers.cfm?abstract_id=928688), p. 3 (last checked 11/23/07) ("whether a loan includes an investment restriction is often more sensitive to changes in firm performance than amendments to interest rates and collateral requirements"). See also, Amir Sufi "Banks Lines of Credit in Corporate Finance: An Empirical Analysis", 22 Review of Financial Studies 1057, 1082 (2009) ("Even controlling for the financial factors leading to covenant violations, a covenant violation has an independently large and statistically significant effect on the availability of lines of credit")

<sup>261</sup> Botazzi, Da Rin & Hellman consider that "... venture capital is a form of financial intermediation where investors can choose how much to become involved with their portfolio companies... Active venture investors can help their portfolio companies in many ways, including giving advice and support, helping with professionalizing the management team, creating strategic alliances, or exercising corporate governance... Venture capitalists can also spur their companies' innovation... However, not all venture capital firms are alike... some are "hands-on," while others are "hands-off" investors..." from Laura Botazzi, Marco Da Rin & Thomas Hellman "Active Financial Intermediation: Evidence on the Role of Organizational Specialization and Human Capital", working paper available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=569602](http://papers.ssm.com/sol3/papers.cfm?abstract_id=569602) (last visited 9/24/08).

companies.”<sup>262</sup> As a result, the internal organization of the lending institutions is likely to determine its adaptation ability and indirectly the efficiency of its decision-making mechanisms.

Most DIP loans are arranged through lending syndicates led by one of the largest financial institutions or by large lending institutions with diversified investment portfolios. Again, to the extent that the analogy between venture financing and reorganization financing holds, it is likely that a controlling lender’s adaptation ability is relatively poor due to its lack of specialization. For example, one of the usual lead DIP lenders is Bank of America. Bank of America provides many different financing services, ranging from asset based finance to treasury management services and declares expertise in industries as diverse as consumer & retail and technology,<sup>263</sup> besides consumer products. As a result, it is highly unlikely that such an institution possesses efficient adaptation abilities that can be used when it gets control of the firm.<sup>264</sup> Naturally, this fact will push the lender decision into favoring quick section 363 sales.

It is important to stress that even though TEB is correct in claiming that “[t]he enterprises whose future is most uncertain tend to be small businesses when they are just starting”,<sup>265</sup> it doesn’t follow from that premise that uncertainty is a dismissible factor. Indeed, uncertainty is present even in old industries. The car making industry is

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<sup>262</sup> See Laura Botazzi, Marco Da Rin & Thomas Hellman “Active Financial Intermediation: Evidence on the Role of Organizational Specialization and Human Capital”, working paper available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=569602](http://papers.ssm.com/sol3/papers.cfm?abstract_id=569602) (last visited 9/24/08), at 2-3.

<sup>263</sup> See <http://www.bankofamerica.com/index.cfm?page=corp>

<sup>264</sup> It appears that venture capital firms in the US privilege limits on business changes. See Steven N. Kaplan, Berk A. Sensoy & Per Stromberg “What Are Firms? Evolution from Birth to Public Companies”, working paper available at <http://www.nber.org/papers/w11581.pdf> (last visited 1/29/2008), at 30

<sup>265</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 Stan. L. Rev. 751, 780 (2002).



more than a century old and nonetheless the current crisis has shown the important degree of uncertainty which it faces. Indeed, distress situations' place the spotlight on the problems confronting a firm (and indirectly an industry) and makes evident that a central issue to address concerns the uncertainty about the future of the industry.<sup>266</sup>

In addition to uncertainty, ambiguity appears to play a role in a controlling lender's decision-making process also.<sup>267</sup> According to Camerer, ambiguity is "known to be missing information".<sup>268</sup> Several experiments, following Ellsberg's famous paradox,<sup>269</sup> have shown that people are prone to have aversion towards ambiguity.<sup>270</sup> Interestingly, a person's attitude towards ambiguity is unrelated to her attitude towards risk.<sup>271</sup> Therefore, the fact that a lender has extensive expertise on decision-making in general (i.e. takes risks neutral decisions) does not immediately translate into adequate decisions when there is ambiguity involved. Problem specific expertise has been identified as an offsetting factor for ambiguity aversion.<sup>272</sup> Despite their ability to analyze investments in general,<sup>273</sup> it is unlikely that controlling lenders will be willing

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<sup>266</sup> Indeed, questions related which potential innovative ideas to implement or how to tweak existing products or services in order to raise their customer appeal, as well as where to diminish costs are central in a reorganization process and to analyze the viability of a firm.

<sup>267</sup> It is unclear whether ambiguity aversion causes the restriction on business plan adaptations or whether both are generated by a different phenomenon or are completely independent.

<sup>268</sup> See Colin F. Camerer "Individual Decision Making", in *THE HANDBOOK OF EXPERIMENTAL ECONOMICS*, John H. Kagel & Alvin E. Roth eds. Princeton University Press, Princeton, N.J 1995, at 645. Ellsberg refers to attitudes toward uncertainty considering that there's another dimension, besides relative desirability of pay-offs and relative likelihood of events, "the nature of one's information concerning the relative likelihood of events". See Daniel Ellsberg "Risk, Ambiguity, and the Savage Axioms" 75 *Quarterly Journal of Economics* 643, 657 (1961)

<sup>269</sup> See Daniel Ellsberg "Risk, Ambiguity, and the Savage Axioms" 75 *Quarterly Journal of Economics* 643, 650-53 (1961). An accessible discussion of the Ellsberg paradox can be found in John M. Dowling & Yap Chin-Fang, *MODERN DEVELOPMENTS IN BEHAVIORAL ECONOMICS: SOCIAL SCIENCE PERSPECTIVES ON CHOICE AND DECISION MAKING*, Hackensack, NJ, World Scientific, p. 57-9 (2007)

<sup>270</sup> See Paul Slovic & Amos Tversky "Who Accepts Savage's Axioms?" 19 *Behavioral Science* 368 (1974)

<sup>271</sup> See Colin F. Camerer "Individual Decision Making", in *The Handbook of Experimental Economics*, John H. Kagel & Alvin E. Roth eds. Princeton University Press, Princeton, N.J 1995, at 646

<sup>272</sup> See Amar V. Bhide, *THE ORIGIN AND EVOLUTION OF NEW BUSINESS*, Oxford University Press, New York, NY (2000), at 97

<sup>273</sup> See section III.A *supra*

to invest on gaining the specific expertise necessary to offset the ambiguity aversion in each particular firm, as it is not what lenders base their business models on.

Intimately related with lenders doubtful ability to cope with uncertainty, is the assessment that other affected parties would make of it. As long as a controlling lender limits the investment opportunity set, it may foster an expectation of failure which in itself could trigger actual failure.<sup>274</sup> It is not the point here that parties which may contract with the reorganizing firm controlled by a lender are going to necessarily trust the firm less than if it wasn't controlled by a lender. The point is far less ambitious. Rather, I emphasize the fact that third parties will doubt the ability of the reorganizing firm to adapt and be successful and hence may charge more for their products or services, perhaps even more than offsetting positive effects generated by lender involvement.

Alternatively, a lender in control may be seen as only willing to pursue his or her interests and this fact, regardless of the social or group welfare implications it may have, may generate detrimental effects. Background information of this sort and the social meaning or reputation of lender control,<sup>275</sup> may be relevant to get people to cooperate, which is essential for cooperative endeavors, like firms are. For example, Liberman, Samuels and Ross, have shown that subjects in their study of a prisoner dilemma situation tend to cooperate much more when the game is labeled as "community" than when it is labeled "wall street".<sup>276</sup> Therefore, if parties contracting

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<sup>274</sup> For a similar point made on start-ups, see Amar V. Bhide, *THE ORIGIN AND EVOLUTION OF NEW BUSINESS*, Oxford University Press, New York, NY (2000), at 72.

<sup>275</sup> Social meaning has been defined as "the expressive dimension of conduct (not excluding speech) in the relevant community... The expressive dimension of conduct is, very simply, the attitudes and commitments that the conduct signals." See Cass R. Sunstein "Social Norms and Social Roles", 96 *Colum. L. Rev.* 903, 925 (1996).

<sup>276</sup> See Varda Liberman, Steven M. Samuels & Lee Ross "The Name of the Game: Predictive Power of Reputations Versus Situational Labels in Determining Prisoner's Dilemma Game Moves", 30

with the firm (i.e. employees) are able to observe that the firm is run by a controlling lender who has a reputation for being a quick- trigger liquidator (closely related to following self-interest only) rather than pushing for reorganizations (assumed to protect other claimants' interests), it is quite likely that for example those employees will believe the lender to be non-cooperative. As a result, the reaction of parties who contract with the debtor firm maybe to defect of any cooperative behavior, generating important losses of social welfare.

Closely related to the non- cooperative behavior mentioned above is another cost not taken into account by defenders of the efficiency of lender control and it relates to the trade credit that a distressed firm has given. Peterson and Rajan explain that

“It is possible that debtors are less willing to repay a distressed firm. Since repayment is enforced by the threat of cutting off future supplies, such threats are less credible when the supplier is distressed. Also, a distressed firm may be less capable of legal action to recover its dues.”<sup>277</sup>

As long as debtors to the DIP perceive that the firm is more likely to stop functioning, i.e. be liquidated, when a lender is in control, as seems entirely plausible from what

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Personality and social Psychology Bulletin 1175, 1177 (2004) (“It is equally clear that the name of the game exerted a considerable effect on the participants’ choices. When playing the Community Game, 67% of the most likely to cooperate nominees and 75% of the most likely to defect nominees cooperated on the first round. When playing the Wall Street Game, 33% of participants with each nomination status Cooperated”)

<sup>277</sup> See Mitchell A. Peterson & Raghuram G. Rajan “Trade Credit: Theories and Evidence”, 10 The Review of Financial Studies 661, 675 (1997). Miwa and Ramseyer make a related point. See Yoshiro Miwa & J. Mark Ramseyer “Trade Credit, Bank Loans, and Monitoring: Evidence from Japan”, working paper, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=843526](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=843526) (last visited 4/16/09). (“Apparently, they borrow from their partners when those partners will lend most cheaply. They borrow from banks when their partners will not. Yet firms do not treat bank loans and trade credit interchangeably. They borrow from banks when they anticipate needing the money for relatively long periods; they turn to trade partners when they face exigencies they did not expect.”)

the literature on lender control suggests, then those DIP debtors incentive to pay will further diminish because they think that they will get cut off anyway. Even if the end result is just delaying the schedule of payments by the DIP trade partners, it will likely mean that a successful reorganization is less likely.

The investment scope restriction, ambiguity aversion and other affected parties' reactions arguments would further suggest that lenders are suboptimal controlling parties not just due to Myers' underinvestment argument or a preference towards low volatility projects, but also due to credibility problems for project developments and alterations: a project modification would require the lender to incur additional investigation costs to assess its profitability while his investment upside would remain constant and capped. The former is just another reason for the lender to disfavor investing new money and would favor a sale of the business, as its expertise lies elsewhere.<sup>278</sup>

#### **IV. Conclusion**

I have shown that broadening the view of the theory of the firm permits to see that lender control poses costs non-investigated before. Specifically, the above discussion shows that lender control social costs are boosted by the costs of lender control discovered under the nexus of explicit contracts. Finally, I exposed the fact that lender control may also constrain the investment opportunity set in order to exclude sizable business plan changes. Therefore, when considering control allocations in lengthy processes as chapter 11, the above analysis suggest that having a controlling lender at the helm may, in some instances, be as bad as having

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<sup>278</sup> See Ronald J. Mann "Strategy and Force in the Liquidation of Secured Debt", 96 Mich. L. Rev. 159, 178 (1997)

equityholders there. It follows that policymakers reflecting on bankruptcy reform would benefit from looking deeper into the effects of either option and analyzing further what mechanisms could be used to prevent the worst outcomes from happening under either scenario. The following section focuses on one of these intuitions, namely lender control liability, to assess its current use and to argue that it should serve to penalize self-serving behavior which runs counter to the optimal use of the assets.

It is important to note that this chapter also has served to uncover that lender control liability theories are not sufficient to correct all the inefficiencies arising out of allocating control to a lender. Because allocation of control is not innocuous in chapter 11 reorganizations, some of the effects it poses on ex ante relationship specific investors cannot be corrected by merely penalizing a controlling lender without at the same time penalizing lender's gain of control. As a result, it is yet to be proven whether a lender's gain of control of business reorganizations is inefficient relative to other control possibilities. Contrary to this conclusion, the finance literature standard model considers that lenders obtaining control contingent on some imperfect signal is the more efficient state of affairs when debtor default appears likely.<sup>279</sup> Nonetheless this literature does not take into account other constituents in their models.<sup>280</sup> As a result, in a broader scenario as the one facing a reorganization judge, it is very much an open question whether affording control to a lender is indeed the most efficient alternative.

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<sup>279</sup> See for example Mathias Dewatripont & Jean Tirole "Biased Principals as a Discipline Device", 8 *Japan and World Economy* 195, 202 (1996).

<sup>280</sup> The standard finance literature assumes incomplete contracts regarding some constituents, i.e. controlling party, but not other non controlling ones.

## **Where did all the Lender Control Liability adjudications go?**

### **I. Introduction**

The first two chapters have shown that DIP lender control may generate ex ante inefficiencies in terms of investment even in the absence of conflict of interests between legal claimholders. This chapter argues that the theory of the firm is further useful in providing a rationale for lender control liability and functionally related theories.<sup>281</sup> Additionally, this chapter suggests that interpretations of what a firm is provide reasons as to why the role of lender control liability theories has been dwarfing under current interpretations.<sup>282</sup> In fact, in this section I will argue that an interpretation of the firms as composed only of explicit contracts has unduly constrained lender control liability considerations.

These control triggered liability theories have been criticized by academics and practitioners alike due to the dire consequences they pose on lending.<sup>283</sup> At roughly the same time, their role has diminished dramatically to the point of almost converting them in a decorative feature of the legal system. In particular, I maintain that broadening the understanding of the firm used by legal adjudicators allows us to refocus on the possible role of lender control and functionally related theories (i.e.

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<sup>281</sup> In this paper I am shying away from the question of whether a corporation, as a group agent, can be and should be subject to liability. For a defense of such an argument, see Philip Pettit “Responsibility Incorporated”, 117 *Ethics* 171 (2007).

<sup>282</sup> See William H. Lawrence “Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing”, 62 *S. Cal. L. Rev.* 1387, 1389 (1989)

<sup>283</sup> See, for example, John C. Joyce “Lender Liability: The Problem Is still with Us”, 115 *Banking L. J.* 477, 483 (1998); J. Dennis Hynes “Lender Liability: The Dilemma of the Controlling Creditor”, 58 *Tenn. L. Rev.* 635 (1991).

equitable subordination) of liability and direct it towards penalizations of a controlling lender's self-serving, opportunistic behavior. Broadening the view of the firm also allows us to clearly distinguish lender control liability theories from other related legal theories such as the absolute priority rule or the fraudulent conveyance law.

This chapter proceeds as follows. Section II describes the dwarfed role that lender control liability theories have nowadays especially if compared to the recent past. Section III investigates rationales behind the dwarfing role of lender liability theories in the United States and argues that it comes about due to the misconception of what the firm is. Section IV argues that other remedies the legal system has, as fraudulent conveyance, are far from perfect substitutes to penalize a controlling lender's opportunistic behavior. Therefore, suggestions that it could be used as substitute for lender control liability theories are inadequate. Section V explores the possibility that lender control liability is understood as a decision rule acting in conjunction with a conduct rule in order to assess whether its limited bite doesn't fully show the influence on behavior that it exercises. Section VI succinctly concludes.

## **II. A System with no Bite**

Lender liability is a body of law broadly recognized in every jurisdiction which describes a contract or tort claim alleged by a borrower or a third party against a lender and due to the lender's conduct. The term encompasses a broad array of causes of actions including fraud, breach of fiduciary duty, breach of implied covenant of good faith and fair dealing, as well as control based theories of liability.<sup>284</sup> The wide span of different yet successful lender liability causes of action made Fischel call it a

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<sup>284</sup> As Lawrence puts it: "Over the years, an impressive array of nearly a dozen legal theories have developed which premise lender liability in part on control of the debtor." See William H. Lawrence "Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing", 62 S. Cal. L. Rev. 1387, 1387-8 (1989).

“booming area of intense concern to lenders and students of commercial law”.<sup>285</sup>

As mentioned above, it is possible to classify the causes of action as arising inside an arm-length lending relationship or as a result of some sort of control rapport. Among the later, we find several causes of action arising out of agency, the creation of a fiduciary relationship, the alter ego or instrumentality and interference. Once a debtor is in bankruptcy, we can add equitable subordination, as well as a one year period to void preferences provided that the debtor was actually insolvent at the time of the transfer, to the former account.

Control inspired theories of lender liability have an important pedigree line in the United States dating at least as far back as *Baltimore & O. Tel. Co. of Baltimore County et al. v. Interstate Tel. Co.*<sup>286</sup> Nonetheless, and despite their increased sophistication, a long line of precedents in this area has not translated into much clarity, at least beyond the objective of preserving equality of distribution.<sup>287</sup> For example, since *In The Matter of Mobile Steel Co.*, in order to subordinate certain claims there is a formally clear test requiring a combination of inequitable conduct and either unfair advantage or injury to other creditors,<sup>288</sup> but what amounts to inequitable conduct remains largely vague. A similar argument can be constructed in the case of

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<sup>285</sup> See Daniel R. Fischel “The Economics of Lender Liability”, 99 Yale L. J. 131, 133 (1989)

<sup>286</sup> See *Baltimore & O. Tel. Co. of Baltimore County et al. v. Interstate Tel. Co.*, 54 Fed. 50 (4<sup>th</sup> Circuit, 1893)

<sup>287</sup> This equality of distribution is no more than a default rule from contract and property law. See Henry Hasmann & Reinier Kraakman “The Essential Role of Organizational Law”, 110 Yale L.J. 387, 407 (2000) (“The default rules of property and contract law in effect provide that, absent contractual agreement to the contrary, each of the entrepreneur's creditors has an equal-priority floating lien upon the entrepreneur's entire pool of assets as a guarantee of performance.”)

<sup>288</sup> See *In The Matter of Mobile Steel Company*, 563 F2d 692, 699-700 (3<sup>rd</sup> Circuit, 1977) (“... three conditions must be satisfied before exercise of the power of equitable subordination is appropriate.

(i) The claimant must have engaged in some type of inequitable conduct; (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.”)



the law of agency for those cases where there is no explicit consent by the agent to be acting on the principal's behalf and subject to the principal's control.<sup>289</sup>

Legal scholars' work has not eradicated the uncertainty either.<sup>290</sup> For instance, Professors Hu and Westbrook have recently considered reasons to impose liability on controlling lenders, which they describe as possibly arising from "considerations about accountability, transparency, and deference to property rights".<sup>291</sup> Nevertheless, they fall short of prescribing a method to think about the problem. As a result, it is not farfetched to think that lender control liability theories have been applied as a reaction to situations strongly suggesting an acute "sense of wrongdoing" from an equality standpoint, rather than as the implementation of a systematic approach to the problems that can potentially arise from lender control.<sup>292</sup>

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<sup>289</sup> See "Restatement of the Law Third, Agency", American Law Institute Publishers, St. Paul, Minnesota Vol. 1 p. 17 (2006). The Restatement defines agency as a "fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act"

<sup>290</sup> For example, Professor Lawrence has considered that "Lender control is neither illegal nor inherently bad. Control, however, is easily subjected to a variety of excesses and abuses, so legal responses are justified to keep such behavior in check." See William H. Lawrence "Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing", 62 S. Cal. L. Rev. 1387, 1390 (1989). It is not clear what exactly constitutes abuse but, as a result of the abuse backed reasoning, some scholars call for the substitution of lender liability by fiduciary duty principles. See William H. Lawrence "Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing", 62 S. Cal. L. Rev. 1387, 1423-30 (1989).

<sup>291</sup> See Henry T. C. Hu & Jay L. Westbrook "Abolition of the Corporate Duty to Creditors", 107 Colum. L. Rev. 1321, 1396 (2007) ("It has long been held that if a creditor takes control of a corporate debtor, the creditor will be exposed to liability if it uses its control in a way that is harmful to other stakeholders. One of the reasons for those doctrines is that such creditor control is often opaque, so that other stakeholders dealing with the debtor do not realize their fate is now in different hands. Closely related is the importance of associating responsibility with power, lest control be irresponsible. A third reason is the importance of preserving bright lines concerning ownership and control of property in a market society.")

<sup>292</sup> Indeed, Fischel claims that "Lender liability cases have led to the creation of an area of commercial law that has not been accompanied by the development of a coherent theoretical framework establishing the rights of lenders and their duties to their borrowers." See Daniel R. Fischel "The Economics of Lender Liability", 99 Yale L. J. 131, 133 (1989)

A more in depth look into prominent lender control liability cases deriving from the Law of Agency and equitable subordination seems to reaffirm this hypothesis. A milestone case from the law of agency is *A. Gay Jenson Farms Co. v. Cargill, Inc.*<sup>293</sup> In *Jenson Farms*, Cargill, the creditor, financed Warren's, the debtor, grain elevator operation and purchased the majority of its grain. Cargill also made constant recommendations to Warren, as it believed that the debtor needed strong paternal guidance.<sup>294</sup> Cargill recommendations were especially relevant as it was part to the same vertical chain of business Warren was.<sup>295</sup> After Warren ceased operations, other creditors sued Cargill under the theory that Cargill became liable as a principal of Warren on contracts made by the debtor with the farmers. Minnesota's Supreme Court affirmed a judgment finding that an agency relationship was established because Cargill became a principal when it assumed de facto control over the conduct of his debtor as an active participant in the debtor's operations, made key economic decisions and decided whether to keep the debtor in existence. The court stated

*"By directing Warren to implement its recommendations, Cargill manifested its consent that Warren would be its agent. Warren acted on Cargill's behalf in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill. Further, an agency relationship was established by Cargill's interference with the internal affairs of Warren, which constituted de facto control of the*

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<sup>293</sup> See *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minnesota Supreme Court, 1981). Another important case involving agency law is *Buck v Nash-Finch Company*, 78 S.D. 334; 102 N.W.2d 84 (Supreme Court of South Dakota, 1960).

<sup>294</sup> See *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 288-9 (Minnesota Supreme Court, 1981) ("At approximately this time, a memo was given to the Cargill official in charge of the Warren account, Erhart Becker, which stated in part: "This organization [Warren] needs very strong paternal guidance."")

<sup>295</sup> It is quite likely that this fact helped the court decide the issue of whether Cargill had control of Warren or not.

*elevator.*”<sup>296</sup>

Despite being frequently cited as a way to explain lender control liability, *Jenson Farms* doesn’t provide a clear understanding of why it is desirable to subject a controlling creditor to liability (when limited liability is readily available for equity holders), what should the extent of that liability be<sup>297</sup> nor what it means to be acting on behalf of the creditor.<sup>298</sup> The same could be said of equitable subordination cases. In the famous *Taylor v. Standard Gas & Electric Co.*,<sup>299</sup> the court found that Standard Gas & Electric had operative control of Deep Rock, the debtor. A majority of Deep Rock's officers were officers or directors of Standard or Standard’s parent corporation. The officers of Deep Rock reported to and were always subject to the direction of officers and directors of Standard. In addition, the fiscal affairs “were wholly controlled by Standard, which was its banker and its only source of financial aid.”<sup>300</sup> When Standard tried to obtain a controlling position in the reorganized firm, the Supreme Court ordered that “No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the Company's assets prior to that of Standard”<sup>301</sup> because Deep Rock was bankrupt as a result of “the abuses in management due to the paramount interest of interlocking officers and

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<sup>296</sup> See *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 291 (Minnesota Supreme Court, 1981).

<sup>297</sup> There is, nonetheless, a limit on the amount of the awards, as lender control liability theories generally have a retributitional character (unless a statute determine otherwise). See “Restatement of the Law Third, Agency”, American Law Institute Publishers, St. Paul, Minnesota Vol. 2 p. 115-23 (2006).

<sup>298</sup> The common Law of Agency requires the agent to further the interests of the principal, but there’s no bright line division of where the interests of the principal ends and where the interests of the agent begins. See “Restatement of the Law Third, Agency”, American Law Institute Publishers, St. Paul, Minnesota Vol. 1, Section 1.01, Comment g (2006) (“Relationships of agency are among the larger family of relationships in which one person acts to further the interests of another and is subject to fiduciary obligations.”)

<sup>299</sup> See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939). Another landmark case involving equitable subordination is *Pepper v. Litton*, 308 U.S. 295 (1939)

<sup>300</sup> See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 311 (1939)

<sup>301</sup> See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 324 (1939)

directors in the preservation of Standard's position, as at once proprietor and creditor of Deep Rock.”<sup>302</sup> Once again, the questions regarding the reason behind the desirability of lender control liability (or the intimately related equitable subordination) and the extent of that liability remain largely unanswered.

Perhaps as a reaction against this lack of theoretical clarity, there has been a steady stream of cases objecting to the existence of lender control liability.<sup>303</sup> The trend can be seen in cases dealing with equitable subordination such as *In The Matter of Mobile Steel Company*,<sup>304</sup> *In re Ludwig Honold Manufacturing Company, Inc.*,<sup>305</sup> *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting*,<sup>306</sup> and *Henry v Lehman Commercial Paper*,<sup>307</sup> and *In the Matter of Clark Pipe and Supply Co., Inc. v Associates Commercial Corporation*,<sup>308</sup> lender control liability under the Worker Adjustment and Retraining Notification Act such as *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*,<sup>309</sup> and *Mike Smith v Ajax Magnathermic Corp., et. al*,<sup>310</sup> lender control liability under the Common Law of

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<sup>302</sup> See *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 323 (1939)

<sup>303</sup> A similar conclusion is given by the Reporter Notes to the Restatement of the Law of Agency. See “Restatement of the Law Third, Agency”, American Law Institute Publishers, St. Paul, Minnesota Vol. 1, Section 1.01, Reporter’s Notes to Comment f (2006) (“In the debtor-creditor context, most courts are reluctant to find relationships of agency on the basis of provisions in agreements that protect the creditor's interests”). See, also, F.H. Buckley “The Termination Decision”, 61 UMKC 243, 278 (1992) (“... more recent decisions are less favorable to [lender control liability] claims”); see also 9 Norton Bankr. L. & Prac. 3d § 174:19 (2008) (“The courts, however, have generally refused to impose fiduciary duties on the lender unless it was in charge of the borrower's day-to-day management.”)

<sup>304</sup> See *In The Matter of Mobile Steel Company*, 563 F.2d 692 (3<sup>rd</sup> Circuit, 1977)

<sup>305</sup> See *In re Ludwig Honold Manufacturing Company, Inc.*, 46 B.R. 125 (Bkrtcy.D.Ea.Penn., 1985)

<sup>306</sup> See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7<sup>th</sup> circuit, 1990)

<sup>307</sup> See *Henry v. Lehman Commercial Paper*, 471 F.3d 977 (9<sup>th</sup> Circuit, 2006)

<sup>308</sup> See *In the Matter of Clark Pipe and Supply Co., Inc. v. Associates Commercial Corporation*, 893 F.2d 693 (5<sup>th</sup> Circuit, 1990)

<sup>309</sup> See *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, 247 F.3d 471 (3<sup>rd</sup> Circuit, 2001)

<sup>310</sup> See *Mike Smith v. Ajax Magnathermic Corp., et. al*, 144 Fed. Appx. 482 (6<sup>th</sup> Circuit, 2005). Another example of this reasoning comes from *Coppola v. Bear Stearns & Co., Inc.* 499 F.3d 144 (2<sup>nd</sup> Circuit, 2007).

Agency such as *Schwan's Sales Enters. v Commerce Bank & Trust Co.*,<sup>311</sup> all of which appear to limit the extent to which remedies on controlling lenders can be applied.<sup>312</sup>

In this counter-wave, the first line of defense against findings of liability arises out of the Common Law of Agency definition of the requirement that the agent should act “on behalf of” the principal. Acting on behalf of another likely generates a fiduciary relationship and then fiduciary duties may arise. Because what accounts as acting on behalf of someone else is somewhat fuzzy, i.e. how to delineate the boundaries of self-interested behavior in a cooperative endeavor and when is it that someone begins to act for someone else instead of merely acting for himself, self-description or formalities gain importance.<sup>313</sup> Therefore, the formality of an agreement between parties on the way forward each time a decision needs to be taken and an explicit or implicit declaration of acting in its own behalf from both parties prevents the lender from being deemed the principal of the debtor firm.<sup>314</sup> The same argument can be used to impede the lender from owing fiduciary duties.

As a result, those formal agreements and declarations serve to maintain the

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<sup>311</sup> See *Schwan's Sales Enters. v. Commerce Bank & Trust Co.*, 397 F. Supp. 2d 189 (U.S. District Court of Massachusetts, 2005)

<sup>312</sup> A notable exception comes from *Citibank, N.A. v. Data Lease Financial Corporation*, 828 F.2d 686 (11<sup>th</sup> Circuit, 1987), where the court reversed a summary judgment which considered that Citibank (the lender) was not a principal of Data Lease (the debtor) (“In determining whether an agency relationship exists between Citibank and the third party defendants, the key issue is control and domination... In his deposition, Joseph Stefan made the following admission: Q. Did you work for Citibank? A. At the bottom of everything the answer would be yes. They put me there and they took me out. Stefan further testified that he worked in close coordination with Citibank on “major matters”, including major changes of policy. Finally, Stefan described his displeasure with Miami National's head of operations and his inability to remove the man from office: Q. Why couldn't you get rid of Mr. Connor? A. He was there at the wishes of Citibank and they would have to remove him.”, *Citibank, N.A. v. Data Lease Financial Corporation*, 828 F.2d 686, 691-2)

<sup>313</sup> A clear signal of the importance of self-description is the ease to establish agency when the agent expressly consents that he will act on behalf and subject to the control of the principal. In this situation, it won't be easy to establish that the agent wasn't furthering the principal's objectives.

<sup>314</sup> A party claiming that the lender was in active control of the borrower will have to bear the burden of proof sufficient of overturning the presumption.

validity of the separate personhood recognition that Organization Law provides. For example, in *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, Chief Judge Becker of the Third Circuit reinforced this separation with an admonition which left the consequences unspoken, as if stating them would have been redundant:

*“...we must be scrupulous in our efforts to distinguish between situations in which a parent/lender has ultimately assumed responsibility for the continuing viability of a company (thus incurring liability for WARN Act violations) and situations in which the borrower has retained the ultimate responsibility for keeping the company active.”*<sup>315</sup>

Most likely due to a real demand for business certainty, the Restatement of the Law of Agency has also established a safe harbor on the related concept of control. As a way of distinguishing what controlling parties may do without becoming principals, the Restatement of the Law of Agency suggests that the difference between mere influence and control depends on whether consent is given by the agent to the exercise of that influence or dominance, i.e. whether the influence comes in the form of recommendations or instructions.<sup>316</sup> But not even all instructions can be considered to

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<sup>315</sup> See *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, 247 F.3d 471, 506 (3<sup>rd</sup> Circuit, 2001).

<sup>316</sup> “A relationship is one of agency only if the person susceptible to dominance or influence has consented to act on behalf of the other and the other has a right of control, not simply an ability to bring influence to bear.” See “Restatement of the Law Third, Agency”, American Law Institute Publishers, St. Paul, Minnesota Vol. 1 p. 28 (2006). A similar test can be found for example in *Chemtool, Inc. v. Lubricant Technologies Inc.* noting that “the test to determine whether a principal-agent relationship exists is whether the alleged principal has the right to control the agent, and whether the alleged agent can affect the legal relationships of the principal.” See *Chemtool, Inc. v. Lubricant Technologies Inc.*, 148 F.3d 742 (7<sup>th</sup> Circuit, 1998). This consensual characteristic sets apart the agency definition of control from the definitions of power in the social sciences. For example, Professor Dowding classifies power in outcome power, “the ability of an actor to bring about or help to bring about outcomes” and social power, “the ability of an actor deliberately to change the incentive structure of another actor or actors to bring about or help to bring about outcomes”, without any references to consent or assent as

account for the existence of control. Negative instructions are not deemed valid indicators of control by a lender. Indeed, comment f to the Restatement of the Law of Agency expresses that

*“[t]he right to veto another’s decision does not by itself create the right to give affirmative directives that action be taken, which is integral to the right of control... Thus, a debtor does not become a creditor’s agent when a loan agreement gives the creditor veto rights over decisions the debtor may make.”*<sup>317</sup>

Considered together, the formality of proclaimed self-interest behavior and the absence of positive instructions given by the lender have been consciously constructed by the Restatement drafters to avoid any possible determination of agency and, by extension, any finding of liability against a “controlling” lender.

As a second part of the strategy, courts combine the previous reasoning with equitable subordination added prongs in those cases where the party who allegedly acted in an inequitable manner was not an insider. As formalism and lack positive instructions indicate that lenders are not in control of the debtor firm, courts do not consider that they are insiders absent other facts that would place the lender in such a position. Then, to subordinate the claims of a non insider the burden of proof is increased. As it was decided in *Henry v. Lehman Commercial Paper*,

*“Where non-insider, non-fiduciary claims are involved, as is the case here, the level of pleading and proof is elevated: gross and egregious conduct will be required before a court will equitably subordinate a*

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the Restatement section 1 comment f does. See Keith Dowding, POWER, University of Minnesota Press, Minneapolis, MN (1996), at 5.

<sup>317</sup> See “Restatement of the Law Third, Agency”, American Law Institute Publishers, St. Paul, Minnesota Vol. 1, Section 1.01, Comment f (2006).

*claim.*”<sup>318</sup>

In the same vein, in *In re Ludwig Honold Manufacturing Company, Inc.*, the court held that “a creditor who is not an insider is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim.”<sup>319</sup>

The counter-wave of cases is heavily defended from a contractual freedom point of view. For example, in *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting*, while overturning a finding of equitable subordination from the Bankruptcy Court, Judge Easterbrook mentioned *in dictum* that

“...we are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do ‘more’ - just how much more resting in the discretion of a bankruptcy judge assessing the situation years later... Courts may not convert one form of contract into the other after the fact, without raising the cost of credit or jeopardizing its availability. Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized.”<sup>320</sup>

This line of reasoning has been embraced by courts in similar situations, as it can be seen in *Trenwick America Litigation Trust v. Ernst & Young*.<sup>321</sup> In *Trenwick*, while discussing a claim for deepening insolvency and the existence of creditor

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<sup>318</sup> See *Henry v. Lehman Commercial Paper*, 471 F.3d 977, 1006 (9<sup>th</sup> Circuit, 2006). This opinion makes the author wonder what then could gross and egregious conduct be.

<sup>319</sup> See *In re Ludwig Honold Manufacturing Company, Inc.*, 46 B.R. 125, 128 (Bkrtcy. D. Ea. Penn., 1985)

<sup>320</sup> See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356-7 (7<sup>th</sup> circuit, 1990).

<sup>321</sup> See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch., 2006)



protection under Delaware Law, the Delaware Chancery Court stated

*“And Delaware public policy is strongly supportive of freedom of contract, thereby supporting the primary means by which creditors protect themselves - through the negotiations of toothy contractual provisions securing their right to seize on the assets of the borrowing subsidiary.”*<sup>322</sup>

Therefore, in order to limit the negative extent of their rulings on the credit market, courts consistently decide that a creditor exercising his contractual rights cannot be subject to wrongdoing.

It becomes apparent, then, that the objective of equality of distribution which has been put forward so far as the rationale behind lender control liability theories may not actually be accomplished, as these theories have little, if any, impact on creditors' (mis)behavior.<sup>323</sup> The impact on lender behavior must indeed be relatively trivial when the trend signaling the absence of lender control liability is combined by a recent steady stream of legal academics claiming that creditors are calling the shots in reorganization proceedings.<sup>324</sup> A similar type of claim can regularly be found in the

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<sup>322</sup> See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 173 (Del. Ch., 2006). In addition, the court considered that “So long as directors are respectful of the corporation's obligation to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equityholders. Even when the firm is insolvent, directors are free to pursue value maximizing strategies, while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective.” See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174-5 (Del. Ch., 2006). Contrast the former to the role of the administrator under the UK Enterprise Act (2002). As Armour and Mokal put it “The new administration regime, by providing for out-of-court appointment by a floating charge holder, is designed to capture many of the benefits of the information acquired by banks about their customers. However, the revised procedure is also designed to ensure that the bank's appointee is genuinely accountable to all creditors.” See John Armour & Rizwaan J. Mokal “Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002”, *Lloyds Maritime and Commercial Law Quarterly* 28, 29 (2005)

<sup>323</sup> It is not my point that creditors' bargaining for protective clauses or debtors' bonding themselves to stringent covenants will lend per se to creditor misbehavior. The point is that misbehavior goes largely undeterred.

<sup>324</sup> See Douglas G. Baird & Robert K. Rasmussen “The End of Bankruptcy”, 55 *Stan. L. Rev.* 751 (2002); Lynn M. LoPucki “The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's

financial literature.<sup>325</sup> Although many situations are likely engineered to prevent any sort of control taking by the lender,<sup>326</sup> it cannot be the case that this is what happens in every case unless all the previous authors were wrong.<sup>327</sup> If we assume that the assessment from these authors is correct, as it seems sensible to do given the shared academic opinion, the question of why lender control liability cases have consistently been solved in favor of the lenders immediately arises.

Alternatively, and more likely, the legal engineering is not geared to prevent

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The End of Bankruptcy”, 56 *Stan. L. Rev.* 645 (2003); Douglas G. Baird & Robert K. Rasmussen “Chapter 11 at Twilight”, 56 *Stan. L. Rev.* 673 (2003); David A. Skeel, Jr. “Creditors’ Ball: The “New” New Corporate Governance in Chapter 11”, 152 *U. Pa. L. Rev.* 917 (2003); David A. Skeel, Jr. “The Past, Present and Future of Debtor-in-Possession Financing”, 25 *Cardozo L. Rev.* 1905 (2004); Stephen Lubben “The “New and Improved” Chapter 11”, 93 *Kentucky Law Journal* 839 (2004); Barry E. Adler “Bankruptcy Primitives”, 12 *Am. Bankr. Inst. L. Rev.* 219 (2004); Jay L. Westbrook “Bankruptcy Control of the Recovery Process”, 12 *Am. Bankr. Inst. L. Rev.* 245 (2004); Harvey R. Miller & Shai Y. Waisman “Is Chapter 11 Bankrupt?”, 47 *B. C. L. Rev.* 129 (2005); Douglas G. Baird & Robert K. Rasmussen “Private Debt and the Missing Lever of Corporate Governance”, 154 *U. Pa. L. Rev.* 1209 (2006); Kenneth M. Ayotte & Edward R. Morrison “Creditor Control and Conflict in Chapter 11”, 1 *The Journal of Legal Analysis* 511 (2009); Douglas G. Baird & Robert K. Rasmussen “The Prime Directive”, 75 *U. Cin. L. Rev.* 921 (2007); Adam Feibelman “Commercial Lending and the Separation of Banking and Commerce”, 75 *U. Cin. L. Rev.* 943 (2007). The disagreement among these authors is relative to the beneficial effects of lender control, not its existence.

<sup>325</sup> See, for example, Sudheer Chava & Michael R. Roberts “How Does Financing Impact Investment? The Role of Debt Covenants”, 63 *Journal of Finance* 2085, 2086 (2008) (“However, the instant that the borrower’s net worth falls below this threshold, regardless of the amount, control rights shift to the creditor, who can then use the threat of accelerating the loan to take any number of actions that may impact the investment policy of the firm (e.g., increasing the interest rate on the loan, shortening the maturity of the loan, reducing the available funds, or directly intervening in the investment decisions of the firm). Thus, the distance to the covenant threshold is irrelevant for the purpose of understanding how the violation and subsequent transfer of control rights impact investment).

<sup>326</sup> There is evidence of this legal engineering. See Randall S. Kroszner & Philip E. Strahan “Bankers on Boards: Monitoring, Conflict of Interests, and Lender Liability”, 62 *Journal of Financial Economics* 415, 417-8 (2001) (“Our analysis shows that bankers tend to be on the boards of firms in which shareholder-creditor conflicts are likely to be relatively unimportant. Typically, these firms are large and stable and have a high fraction of tangible assets and a low level of short-term financing in their capital structure... At low levels of risk, the benefits of monitoring appear to dominate, while at higher levels of risk, the conflict of interest costs and lender liability concerns become more important.” “There is an important tradeoff in the U.S. between the benefits to firms of active monitoring and the costs of potential conflicts of interest and lender liability”). In addition, the use of chapter 11 sales is indicative of measures taken to avoid lender control liability.

<sup>327</sup> In addition, it could be claimed that the recent escalation of cases claiming “deepening insolvency” has been a practical answer to courts closing the lender control liability possibility. On the escalation deepening insolvency cases, see Gerald L. Blanchard “Recent Developments in the Area of Lender Liability Law”, *Ann. Surv. of Bankr. Law Part I S 3* (2006) (“the year saw continued development in the area of deepening insolvency”).

control-taking by the lender but to prevent liability adjudications based on formal conceptions of control acquisition. Under this scenario, lenders do obtain some sort or degree of control in some DIP lending situations but the Law of Agency's over comprehensive safe harbor doesn't admit any sort of control acquisition findings arising from veto power means. If this is indeed what happens, lending practices and case law would seem to be describing completely different and possibly unrelated situations. The next section will discuss the possible justification grounds for this conceptual disconnect in the context of lender control liability adjudications.

### **III. Beyond the Explicit Nexus of Contracts Paradigm**

In this section, I argue that, at least in part, the previously described "control disconnect" derives from an understanding of the theory of the firm akin to the explicit nexus of contracts theory. As it was noted in chapters I and II, the explicit nexus of contracts theory looks at firms as mere ways of linking contracts which fully pay everyone but shareholders their opportunity costs.<sup>328</sup> The explicit nexus of contracts theory is firmly based on contractual freedom as a wealth creating mechanism. As parties are assumed to only enter into contracts which they deem beneficial, contractual freedom leads to Pareto efficient behavior. The string of thought is as follows: if freedom of contracts is limited, then the possible set of contract permutations and combinations that a firm may produce or, in the same vein, that may generate a firm gets reduced. As a result, it is possible that any restriction to contractual freedom will cause value enhancing combinations to be left out and social efficiency not to be achieved. Following this logic, it comes to no surprise to encounter claims like the ones found in the *Kham Shoes* or *Trenwick* opinions cited

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<sup>328</sup> See Luigi Zingales "In search for New Foundations", 55 Journal of Finance 1623, 1630 (2000).

above.<sup>329</sup>

An unconditional declaration that contractual freedom is always a wealth creation technology requires several assumptions to hold.<sup>330</sup> Chief among them is that either there's a perfect alignment between private and social costs<sup>331</sup> or, if they are not aligned, that the Coase theorem hold, i.e. that transaction costs are small enough not to preclude optimal negotiations among parties.<sup>332</sup> The explicit nexus of contracts paradigmatic view of the firm picks up the first of these assumptions, as everyone who transacts with the firm is by assumption fully paid and therefore is deemed better off. This theory disregards as structurally meaningful or constitutive to what a firm is that private and social costs may diverge.<sup>333</sup> It immediately follows that freedom of contracts should not be limited in the firm context, as alignments between private and social costs are not affected by the firm.<sup>334</sup>

If, as I am suggesting, firms are understood as explicit nexus of contracts, it comes to no surprise that the Law of Agency possesses a negative control safe harbor

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<sup>329</sup> For another example, see *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, 247 F.3d 471, 502 (3<sup>rd</sup> Circuit, 2001) ("We do not intend to create a jurisprudence that discourages loans in general or rescues of troubled business enterprises in particular")

<sup>330</sup> Even with the assumptions holding, not everyone blindly believes on the omnibenevolence of the market as a wealth creating mechanism. See Susan Rose-Ackerman "Inalienability and the Theory of Property Rights", 85 Columbia Law Review 931, 932 (1985) ("Most of this work, moreover, has been excessively confident in the workings of the private market once property rights are firmly established and therefore views restraints on alienation with a great deal of skepticism.")

<sup>331</sup> The difference between private and social costs usually arises where externalities, imperfections in information or coordination difficulties are involved. See Susan Rose-Ackerman "Inalienability and the Theory of Property Rights", 85 Columbia Law Review 931, 938-40 (1985)

<sup>332</sup> See Ronald H. Coase "The Problem of Social Cost", 3 Journal of Law and Economics 1, 6-8 (1960). It is quite telling that Coase himself was looking for alternatives to Pigouvian taxes and damages, not ruling them out.

<sup>333</sup> Indeed, the explicit nexus of contracts theory of the firm does not address that issue, making it uncertain what the theory would predict on the treatment of cases where private and social costs are not the equal. This theory seems to allow private and social costs to diverge only in non-constitutive firm related issues.

<sup>334</sup> In fact, it would be impossible to present contractual limitations under the explicit nexus of contracts theory, as it believes that the firm is nothing more than a way to diminish agency costs (monitoring, bonding and residual loss costs).

and the complete adherence it has from courts in an area of law where equitable considerations are at the basis of juridical opinions.<sup>335</sup> The safe harbor adherence to formalities ensures that management will be considered a representative of the residual owners, either shareholders or unsecured claim holders, and therefore “assures” that wealth creating contracts are not precluded.<sup>336</sup> This misconception of the structural nature of the firm generates a misleading formula, as logical consistency precludes arriving to conclusions that deviate from a stark defense of contractual freedom.

As a result, it follows that the understanding of the theory of the firm determines what the causes for unfairness and damages can be.<sup>337</sup> If two parties enter into a contract without incurring in any sort of fraudulent or misrepresenting behavior, then because they have acted within the scope of their contractual freedom and by assumption other parties are paid their full opportunity cost for their services, the parties’ conduct cannot be considered unfair nor produce damages unless the contract has been breached.<sup>338</sup> The preceding reasoning has been the traditional way of looking at lender control liability, as can be seen in Fischel’s analysis.<sup>339</sup> The same conceptual

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<sup>335</sup> I.e. equitable subordination.

<sup>336</sup> Note that economic agency theory, on which the explicit nexus of contracts is heavily dependent on, allows for decision bodies to be captured. As a result, it could be argued that the safe harbor from the Law of Agency doesn’t ensure that the directors will be running the firm in the best interest of all the financial claimants. But this sort of criticism would be having a role at a different level, as it would be discussing agency costs within the firm structure and not the defining characteristics of firms per se under the explicit nexus of contracts theory.

<sup>337</sup> This is very important, as some courts recognize that certain cases may generate equitable subordination without a specific proof of inequitable conduct. See *In The Matter of Virtual Network Services Corporation*, 902 F.2d 1246, 1250 (7<sup>th</sup> Circuit, 1990) (“In sum, we conclude that § 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors”) See also *United States v. Noland*, 517 U.S. 535, 540 (1996)

<sup>338</sup> This is where control by a lender becomes important, as without control a lender could not opportunistically breach a contract

<sup>339</sup> For example, when Fischel discusses damages arising due to lender liability he says that “the relationship between a lender and a borrower is contractual.” See Daniel R. Fischel “The Economics of Lender Liability”, 99 Yale L. J. 131, 148 (1989). Also, when considering the source of liability, Fischel looks at opportunistic behavior: “Opportunistic behavior occurs whenever one party attempts to obtain, at the expense of the other, a benefit not contemplated by the initial agreement, either explicitly or implicitly. Thus, whenever a lender attempts to renegotiate with the borrower for better terms when

framework can be observed, for example, in *Adams v. Erwin Weller Co.*,<sup>340</sup> a case arising for responsibility for backpay and benefits owed to employees when their employer closed without giving them sixty days written notification, as required under the Worker Adjustment and Retraining Notification (WARN) Act.<sup>341</sup> A class of employees moved to collect against Westinghouse Credit Corporation, the main lender of the employer, under the theory that through its financing it had become the principal. While denying the employees claim, Judge Fagg stated Westinghouse Credit Corporation's "use of legitimate financial controls to protect its security interest does not make [Westinghouse Credit Corporation] an employer under WARN."<sup>342</sup> Again, contractually agreed controls assumed ex ante to be beneficial are not to be understood as unfair later on, especially when due regard was given to use the Law of Agency's safe harbor.

Interestingly, lender control liability theories interpreted under the umbrella of the explicit nexus of contracts theory would generate a result essentially equal to that of the absolute priority rule for those cases where the lender did not incur in any fraudulent or misrepresenting behavior.<sup>343</sup> The absolute priority rule codifies a judge-made rule providing that reorganization plans need to provide for full compensation of higher priority claimholders before they can assign any value to lower priority ones.<sup>344</sup>

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there is no basis for doing so, the lender is behaving opportunistically". See Daniel R. Fischel "The Economics of Lender Liability", 99 Yale L. J. 131, 138 (1989). Even though Fischel talks about implicit contract terms, he doesn't view the existence of non-contractability as a possibility, as on this particular point he relies on the analysis of Muris, who explicitly considers that "the victim would have avoided the problem [of opportunism] so long as the costs of prevention were less than the expected costs of the opportunism." See Timothy J. Muris "Opportunistic Behavior and the Law of Contracts", 65 Minn. L. Rev. 521, 524 (1981).

<sup>340</sup> See *Adams v. Erwin Weller Co.*, 87 F.3d 269 (8<sup>th</sup> Circuit, 1996)

<sup>341</sup> See 29 U.S.C. §§ 2101-2109

<sup>342</sup> See *Adams v. Erwin Weller Co.*, 87 F.3d 269, 272 (8<sup>th</sup> Circuit, 1996)

<sup>343</sup> See 11 U.S.C. §1129(b)(2)(B)(ii) ("the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property")

<sup>344</sup> See *In re Iridium Operating LLC*, 478 F.3d 452, 463 (2<sup>nd</sup> Circuit, 2007)

Therefore, anyone with higher priority who obtains less than full compensation can ask the court to impede others of lower priority to obtain any compensation until his claim is fully satisfied. The link between the absolute priority rule and lender control liability theories appears natural as both of them share the objective of equality of distribution.

The absolute priority rule is essentially a distributive rule geared to allocate whatever assets the debtor firm already has but which doesn't look into how it was that the firm came to have those assets or how the assets are sold. Absent fraud or misrepresenting behavior, the explicit nexus of contracts theory of the firm taken together with agency law notions of negative control operationalizes lender control liability to follow the strict order and instructions arising out of the contracts between claimholders and the firm, as it cannot work to recover any extra assets. Then, at least for voluntary creditors,<sup>345</sup> lender control liability would generate at most that same result as the absolute priority rule, reducing it to a distributive rule. Hence, if we assume that claimholders would prefer to seek redress using the absolute priority rule as they would obtain the same results and it would be easier to plead, redundancy and lower costs would be a reason attempting against the usage of lender control liability. Then, redundancy and lower costs would explain its dwarfing.

Only after we move away from the explicit nexus of contracts paradigm and its stringent assumptions, can lender control liability theories regain a proper role. The recognition of the possibility of asset specific investments and/or implicit contracts allows us to assign those theories a proper function and not merely replicate the distributive function of the absolute priority rule. The focus of these theories should be

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<sup>345</sup> Intuitively, I believe that the reasoning applies to involuntary creditors also.

dynamic and move beyond immediate distributive concerns recognizing that resource allocation is not neutral for efficiency considerations. Further, their focal point should be on efficiency based analysis and aim towards penalizing self-serving behavior that a controlling lender imposed on the firm when that behavior was counter to socially desirable behavior.

#### **IV. Fraudulent Conveyance Law as a substitute?**

An interesting question is whether lender control liability theories have been dwarfing because another analogical remedy is available. The preceding discussion suggests that an understanding of the theory of the firm as constituted of explicit nexus of contracts could have conflated absolute priority questions with lender control liability ones because claimants can essentially obtain the same redress. As what a claimant may get is similar and the absolute priority rule is easier to plead, then lender control liability is chosen in fewer occasions. An alternative explanation is possible: that the results sought by lender control liability, even after dropping the explicit nexus of contracts theory of the firm, can be achieved through other means, maybe through the use of fraudulent transfer law.<sup>346</sup> If the latter was the correct explanation for lender control liability, lender control liability theories would have been replaced by a different preferred substitute, one that maintained the possibility of obtaining redress beyond the juridical corset imposed by the explicit nexus of contracts understanding of the firm.

Traced back at least to the Statute of 13 Elizabeth, ch. 5 (1571),<sup>347</sup> fraudulent conveyance law has obtained reception in both the federal bankruptcy laws<sup>348</sup> and

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<sup>346</sup> I'm indebted to Frederick Tung for pointing this connection to me.

<sup>347</sup> See 5 *Collier on Bankruptcy* ¶ 548.01 (15th Ed. Revised).

<sup>348</sup> See 11 U.S.C. Section 548



state statutory law through the adoption of the Uniform Fraudulent Transfer Act.<sup>349</sup> By fraudulent conveyance law we understand the set of rules aimed to impede transactions whose main objective is to hinder, delay, or defraud any creditor or group of creditors or to discourage transactions that, even without actual fraudulent intent, are prejudicial to any creditor or group of creditors, because such transfers are made for less than reasonably equivalent value.<sup>350</sup> At the heart of the matter is the idea of debtors trying to shortchange their creditors. Baird and Jackson considered that the Statute of 13 Elizabeth “was intended to curb what was thought to be a widespread abuse” at that moment, when England had “certain sanctuaries into which the King’s writ could not enter”, such as the interior of churches.<sup>351</sup> Indeed, Baird and Jackson explained the feeling in England at the time of the enactment of this Statute:

*“It was thought that debtors usually removed themselves to one of these precincts only after selling their property to friends and relatives for a nominal sum with the tacit understanding that the debtors would reclaim their property after their creditors gave up or compromised their claims.”*<sup>352</sup>

Scholars generally agree that without fraudulent conveyance law economic activity could be grossly hindered. As Rose-Ackerman puts it,

*“[A] person who became insolvent could simply give away all his assets to family and friends, go bankrupt, and then accept reciprocal*

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<sup>349</sup> The Uniform Fraudulent Transfer Act was promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1984. The original text is available at <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/ufta84.htm>

<sup>350</sup> “The purpose of the fraudulent conveyance doctrine is to prevent assets from being transferred away from a debtor in exchange for less than fair value, leaving a lack of funds to compensate the creditors.” See 5 *Collier on Bankruptcy* ¶ 548.01 (15th Ed. Revised).

<sup>351</sup> See Douglas G. Baird & Thomas H. Jackson “Fraudulent Conveyance and its Proper Domain”, 38 Vand. L. Rev. 829, 829 (1985).

<sup>352</sup> See Douglas G. Baird & Thomas H. Jackson “Fraudulent Conveyance and its Proper Domain”, 38 Vand. L. Rev. 829, 829 (1985).

*gifts from them afterwards. This practice would introduce an element of risk into the making of loans that would serve no productive purpose. Ex ante the volume of loans would be inefficiently low and interest rates inefficiently high to take account of this possibility of hiding assets from creditors.”*<sup>353</sup>

Inspired by Rose-Ackerman’s intuitive argument, Heaton has used an incomplete contracts framework to explain fraudulent conveyance law’s role.<sup>354</sup> Heaton believes that debtors are unable to commit not to fraudulently transfer assets in bad states of the world because contracts are inherently incomplete.<sup>355</sup> Hence, fraudulent conveyance law is a non-contractual legal rule which “overcomes contractual incompleteness by providing a way to recover against *transferees*... by voiding the transactions that transferred assets to them.”<sup>356</sup> Through this mechanism, the legal system avoids the need of parties to contractually over-constrain ex ante the debtor’s business decision making while, at the same time, “alleviating the contractual incompleteness that diminishes debt capacity.”<sup>357</sup> As a result, the contracting possibility set is enlarged. Additionally, transactions costs are saved as contracts need not try to fill in all types of incompleteness.<sup>358</sup>

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<sup>353</sup> See Susan Rose-Ackerman “Inalienability and the Theory of Property Rights”, 85 Columbia Law Review 931, 950 (1985)

<sup>354</sup> See J. B. Heaton “Incomplete Financial Contracts and Non-contractual Legal Rules: The Case of Debt Capacity and Fraudulent Conveyance Law”, 9 Journal of Financial Intermediation 169 (2000).

<sup>355</sup> See J. B. Heaton “Incomplete Financial Contracts and Non-contractual Legal Rules: The Case of Debt Capacity and Fraudulent Conveyance Law”, 9 Journal of Financial Intermediation 169, 171 (2000).

<sup>356</sup> See J. B. Heaton “Incomplete Financial Contracts and Non-contractual Legal Rules: The Case of Debt Capacity and Fraudulent Conveyance Law”, 9 Journal of Financial Intermediation 169, 171 (2000).

<sup>357</sup> See J. B. Heaton “Incomplete Financial Contracts and Non-contractual Legal Rules: The Case of Debt Capacity and Fraudulent Conveyance Law”, 9 Journal of Financial Intermediation 169, 179 (2000).

<sup>358</sup> Besides fraudulent conveyance law, social norms may also diminish contractual incompleteness and may also save on transaction costs. See Ramon Casadesus-Masanell & Daniel F. Spulber “Trust and Incentives in Agency”, 15 S. Cal. Interdisc. L. J. 45, 58-61 (2005).

Fraudulent Conveyance law is especially attractive in a context where the explicit nexus of contracts paradigm dominates because it doesn't require any analysis of what a firm is or should be and therefore allows for redress where lender control liability wouldn't be available. Under one of its options, merely showing that less than reasonably equivalent value is given to the debtor for the transfer of an asset turns the transaction voidable.<sup>359</sup> Therefore, fraudulent conveyance law appears as a great option for prejudiced non-controlling creditors.

Despite the former suggestion, I believe that Fraudulent Conveyance Law is a far from perfect substitute for lender control liability theories. At the heart of the problem is the transaction focus of fraudulent conveyance law which limits its ability to capture the complexities of firm value dilution. An example will help to describe this point. Assume that a debtor firm has 3 assets. These three assets can be used altogether, separately or in any pair combination. Further, assume that there are complementarities which can be obtained by using a combination of the assets instead of them separately. Even though there are complementarities to the joint use of the different assets, it is easier to sell them separately because there exists a more liquid, closer to complete market for each of the assets. Therefore, there is a higher probability to sell at a discount when selling the assets together than when selling them separately, even though it is common knowledge that they are worth more if

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<sup>359</sup> See 11 U.S.C. Section 548(a)(1)(B) (“(a)(1)(B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.”) In the same vein, see Section 4(a)(2) of the UFTA.

operated jointly.

Additionally, let's assume that together the assets are worth 100 (without discount) and that, if sold separately, they are worth 80. The lender who is in control is owed 70 and the non-controlling creditors (assumed to be the only other claimants) are owed 50. As the controlling lender has nothing to gain from a joint sale because he is owed less than the value of the assets sold separately and the discount volatility could eventually hurt him, he decides to put them up for sale seriatim, using a properly designed auction. This type of structure to sell the assets is completely permissible under section 363 of the Bankruptcy Code and frequently employed, as debtor firms decide how to dispose of their assets.<sup>360</sup> Indeed, it is likely that a Bankruptcy Court looks with better eyes partial disgorgements of assets than sales of all the assets at the same time, as one of the relevant factors suggested by the Second Circuit to take into account in order to approve section 363(b) sales is to look at "the proportionate value of the asset to the estate as a whole".<sup>361</sup> Finally, let's assume that the assets get allocated to people unrelated to the controlling lender and price paid for each asset is well within that of the competitive market range.<sup>362</sup> As it follows from the description of the example, non-controlling lenders get less under this exit option. Would

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<sup>360</sup> See Douglas G. Baird & Robert K. Rasmussen "The End of Bankruptcy", 55 Stan. L. Rev. 751, 787 (2002) ("When the number of creditors of a financially distressed firm is small enough, sales do proceed. When the number of investors is large, however, those in control of the firm (typically its senior creditors) are likely to use Chapter 11 to sell the assets of the firm as a going concern. Chapter 11 provides a mechanism for selling assets free and clear of all claims even before a plan of reorganization is put in place.")

<sup>361</sup> See *In Re The Lionel Corporation v. The Lionel Corporation*, 722 F.2d 1063, 1071 (2<sup>nd</sup> Circuit, 1983). Other relevant factors mentioned by the Second Circuit are "the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value."

<sup>362</sup> See *Willemain v. Kivitz*, 764 F.2d 1019, 1022 (4<sup>th</sup> Circuit, 1985) ("Initially, "value" has repeatedly been defined as 75% of the appraised value of the asset.")

fraudulent conveyance law be useful to the non-controlling lenders?

The most likely answer is no. A court looking at a fraudulent conveyance law claim under this scenario would first try to assess if there was fraudulent intent. As the controlling lender was merely making a decision based on the risk of the discount and not trying to hinder, delay or defraud the non-controlling lenders, it seems almost certain that the court would decide that this was not a case of fraud. Then, the court could examine the constructive fraud possibility. In order to do so, the court would ask itself, *seriatim*, whether there was reasonably equivalent value obtained by the debtor firm for each of the transferred assets. As the answer is by the example framework affirmative, the court would be obliged to determine that none of those transfers, even though value diminishing from an *ex ante* perspective, accounted to a fraudulent transfer. Hence, no redress would be obtained by the other claimants.

It could be argued that key to the non-operation of Fraudulent Conveyance Law is the structure of the sale. Then, and regardless of the strategic incentives generated, Fraudulent Conveyance Law could protect other claimants when all the assets are sold together. But even this case is restricted. In fact, there's a fairly long line of precedents affirming that obtaining at least 75 percent of the appraised value of the asset on a sale would be fair and reasonable consideration.<sup>363</sup> Therefore, the possibility of losing up to 25 percent of value, especially if all the loss arose out of lost firm specific investments, would leave Fraudulent Conveyance Law as an inadequate protection mechanism for other claimants. As a result of the previous reasoning, only if the size of the loss is bigger than 25 percent and provided that the appraisal value is

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<sup>363</sup> See *In re Rock Industries Machinery Corp.*, 572 F.2d 1195, 1197 (7<sup>th</sup> Circuit, 1978); *Greylock Glen Corporation v. Community Savings Bank*, 656 F.2d 1, 4 (1<sup>st</sup> Circuit, 1981); *Willemain v. Kivitz*, 764 F.2d 1019, 1022 (4<sup>th</sup> Circuit, 1985)

made taking into account firm specific investments,<sup>364</sup> will Fraudulent Conveyance Law act as relatively perfect substitute to lender control liability.<sup>365</sup>

As we can see, even if fraudulent conveyance law can be thought as a substitute to lender control liability theories, it is a rather imperfect, non-equivalent one. Therefore, it is very unlikely that a move to the use of fraudulent conveyance law as the legal technology to prevent abuses from lender control has caused lender control liability theories' use to dwarf. In the next section, I will suggest a possible new test in order to reposition lender control liability as a deterrent to value diminishing actions by controlling lenders.

## **V. Diverging Standards?**

A different rationale for the current construction of lender control liability cases arises out of behavioral ideas. Dan-Cohen has argued that conduct rules and decision rules are different, and that the difference is important because each rule is aimed at different actors.<sup>366</sup> To stress his point, he imagines a world where there is an "acoustic separation" allowing actors to receive essentially different messages which serve to complement each other.<sup>367</sup> For instance, Dan-Cohen believes that by thinking of the defense of duress in criminal law as a decision rule instead of a conduct one allows the legal system to keep its framework fixed:

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<sup>364</sup> This point is not minor: if the appraisal is based not taking into consideration firm specific investments, then the utility of using Fraudulent Conveyance Law as a substitute for lender control liability would likely disappear.

<sup>365</sup> It should be noted that if specific investments are going to be lost due to the asset sale the individual buyer willingness to pay for those assets will be made without considering those specific investments. As a result, the market value of those assets will be an inadequate way to account for specific investments.

<sup>366</sup> See Meir Dan-Cohen "Decision Rules and Conduct Rules: An Acoustic Separation in Criminal Law", 97 Harv. L. Rev. 625 (1984)

<sup>367</sup> See Meir Dan-Cohen "Decision Rules and Conduct Rules: An Acoustic Separation in Criminal Law", 97 Harv. L. Rev. 625, 630-4 (1984)

“... even when external pressures impel an individual toward crime, the law should by no means relax its demand that the individual make the socially correct choice.”<sup>368</sup>

This example elicits that a clear distinction may exist between the decision rule and the conduct rule and that logically it doesn't necessarily follow that both should be equal. To make a particular decision rule equivalent to its conduct rule counterpart will depend on a normative assessment.<sup>369</sup>

Melvin Eisenberg picks up these concepts in the corporate context to distinguish between standards of conduct and standards of review or liability.<sup>370</sup> Eisenberg considers that standards of conduct in corporate law are not merely aspirational.<sup>371</sup> Specifically, he believes that there is a clear benefit arising from the divergence of the standard of conduct (i.e. duty of care) and that of liability (i.e. business judgment rule). The former works in parallel to the latter so that the legal system can make good use of the expressive function of law to control or influence behavior.<sup>372</sup> Eisenberg considers that the benefits arising from the expressive function of law can be seen for instance when a prudent lawyer gives advice as it will likely be

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<sup>368</sup> See Meir Dan-Cohen “Decision Rules and Conduct Rules: An Acoustic Separation in Criminal Law”, 97 Harv. L. Rev. 625, 633 (1984)

<sup>369</sup> In other words, the equivalence can be considered “a matter of prudential judgment”. See Melvin A. Eisenberg “The Divergence of Standards of Conduct and Standards of Review in Corporate Law”, 62 Fordham L. Rev. 437, 437 (1993)

<sup>370</sup> “A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.” See Melvin A. Eisenberg “The Divergence of Standards of Conduct and Standards of Review in Corporate Law”, 62 Fordham L. Rev. 437, 437 (1993) (italics in the original).

<sup>371</sup> See Melvin A. Eisenberg “The Divergence of Standards of Conduct and Standards of Review in Corporate Law”, 62 Fordham L. Rev. 437, 464 (1993). Further, he considers that “the standards of review in corporate law pervasively diverge from the standards of conduct.” See Melvin A. Eisenberg “The Divergence of Standards of Conduct and Standards of Review in Corporate Law”, 62 Fordham L. Rev. 437, 438 (1993)

<sup>372</sup> See Melvin A. Eisenberg “The Divergence of Standards of Conduct and Standards of Review in Corporate Law”, 62 Fordham L. Rev. 437, 464 (1993). This function of law refers to “expressing social values and... encouraging social norms to move in particular directions.” See Cass R. Sunstein “Social Norms and Social Choice”, 96 Colum. L. Rev. 903, 953 (1996).

based on the standard of conduct. The same benefit appears when corporations create their codes of conduct, as firms become more likely to follow the standard of conduct rather than the standard of review.<sup>373</sup> Hence, behavior could potentially be affected in a socially desirable way by having a separate conduct and decision rule:<sup>374</sup> the standard of conduct would help create or maintain social norms,<sup>375</sup> which are informal means of facilitating coordination of social conventions and which have the significant benefit of being self-enforced.

The statutory standard of conduct could potentially be strengthened by judicial commentary. Edward Rock believes that Delaware judges engage in “corporate law sermons” of moralistic nature which further reinforce beneficial norms of conduct.<sup>376</sup> Miller believes that these judicial commentaries are especially fruitful because directors are motivated by a desire to “act according to appropriate norms of behavior” and due to fears of judicial criticism in the opinions.<sup>377</sup> As a result, liability standards are indirectly strengthened by the standards of conduct available.

Applying this theory to the lender control liability situation suggests that the stringent standard of review arising out of comment f to the Restatement of the Law of

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<sup>373</sup> See Melvin A. Eisenberg “The Divergence of Standards of Conduct and Standards of Review in Corporate Law”, 62 Fordham L. Rev. 437, 464 (1993).

<sup>374</sup> On the use of social norms to affect behavior, see generally Cass R. Sunstein “Social Norms and Social Choice”, 96 Colum. L. Rev. 903 (1996). For an application of those concepts to corporate law, see Melvin A. Eisenberg “Corporate Law and Social Norms”, 99 Colum. L. Rev. 1253 (1999).

<sup>375</sup> Social norms are generally recognized as important drivers of behavior. See, for example, Ramon Casadesus-Masanell & Daniel F. Spulber “Trust and Incentives in Agency”, 15 S. Cal. Interdisc. L. J. 45, 47 (2005) (“social norms, legal duties, and market standards establish enforcement mechanisms that enhance the contractual performance of agents by supplementing or replacing explicit contractual incentives... social norms, legal duties, and market standards reduce transaction costs by avoiding the need to spell out fully contingent contracts and by allowing principals and agents who are not well acquainted with each other to form contracts.”)

<sup>376</sup> See Edward B. Rock “Saints and Sinners: How Does Delaware Corporate Law Work?”, 44 UCLA L. Rev. 1009, 1016 (1997).

<sup>377</sup> See Geoffrey P. Miller “A Modest Proposal for fixing Delaware’s Broken Duty of Care”, Columbia Business Law Review 319, 327-8 (2010).



Agency (veto rights) may purposely be different from requiring fiduciary duties to a controlling lender. In the later (standard of conduct), the aim would be directed to influence behavior towards the desired goal while in the former (standard of liability) the objective would be akin to allow for the necessarily tough decisions to be made, under the assumption that a more comprehensive liability standard would impede optimal decision making. Hence, a greater social cost would result from unifying the decision and conduct rule in either extreme.

Dan-Cohen's idea is interesting because it elicits that the law may use its tools to achieve desirable outcome in subtle ways when faced with complex situations, where a straight forward legal answer may be suboptimal.<sup>378</sup> This issue should not be overlooked as even Nobel laureate winner Kenneth Arrow considers that optimal allocation of resources requires more than merely economic incentives.<sup>379</sup> The question we face is whether lender control liability divergence, as currently stated, is a proper vehicle to influence behavior in the desired way or not, and I believe the answer is in the negative due to the characteristics of the standard of liability and the players repeated involvement in these matters.

As we have seen formalism in communication between lender and DIP, generate a standard of liability which basically equals to the following: if a lender

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<sup>378</sup> If a reductionist view is taken where there are only standards of review, it would "obscure the character of law as a means of social control in general, and as a means of guiding behavior in particular." See Melvin A. Eisenberg "The Divergence of Standards of Conduct and Standards of Review in Corporate Law", 62 Fordham L. Rev. 437, 462 (1993).

<sup>379</sup> See Kenneth J. Arrow "The Economics of Moral Hazard: Further Comment", 58 Am. Econ. Rev. 537, 538 (1968) ("Because of the moral hazard, complete reliance on economic incentives does not lead to an optimal allocation of resources in general. In most societies alternative relationships are built up which to some extent serve to permit cooperation and risk sharing... One of the characteristics of a successful economic system is that the relations of trust and confidence between principal and agent are sufficiently strong so that the agent will not cheat even though it may be 'rational economic behavior' to do so.")

doesn't give positive instructions, then there's no lender control. Hence, it would be fair to qualify the "standard of liability" as a rule rather than a standard. The customary law and economics analysis on the choice between rules and standards tells us that frequency of use and adjudication are the key determinants.<sup>380</sup> The more frequent a regulated activity is the more preferable a rule (relative to a standard) becomes, as designing a rule for a rare scenario is too costly.<sup>381</sup> Similarly, the more frequent the adjudication instances are, the less preferable a standard is.

It is doubtful whether lender control liability use and adjudication frequency is large enough to require a rule, which would point to an inefficient legal choice. But regardless of whether a rule or a standard in the case of lender control liability is preferable under customary law and economics analysis, a standard of conduct's possibility of influencing a standard of liability depends to a large extent on the ambiguity or vagueness of the later.<sup>382</sup> As Feldman and Harel express it

"[T]he less specific the legal norm is, the more likely people will base their understanding of it on social norms. Thus, individuals are likely to interpret a legal standard in light of the social norm. In contrast, greater specificity of legal norms often precludes such an interpretation."<sup>383</sup>

As rules are more generally more rigid or fixed, it follows that the standard of conduct

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<sup>380</sup> See, generally, Louis Kaplow "Rules versus Standards: An Economic Analysis", 42 *Duke Law Journal* 557, 563-4 (1992).

<sup>381</sup> The different arises from the cost structure of the regulation: while standards are cheaper to create than rules, they are more expensive to implement. See Louis Kaplow "Rules versus Standards: An Economic Analysis", 42 *Duke Law Journal* 557, 573 (1992).

<sup>382</sup> See D. Gordon Smith "A Proposal to eliminate Directors Standards from the Model Business Corporation Act", 67 *University of Cincinnati L. Rev.* 1201, 1206 (1999); Yuval Feldman & Alon Harel "Social Norms, Self-Interest and Ambiguity of Legal Norms: An Experimental Analysis of the Rule vs. Standard Dilemma", 4 *Review of Law and Economics* 81, 88 (2008).

<sup>383</sup> See Yuval Feldman & Alon Harel "Social Norms, Self-Interest and Ambiguity of Legal Norms: An Experimental Analysis of the Rule vs. Standard Dilemma", 4 *Review of Law and Economics* 81, 89 (2008) ("More specifically, we shall argue that the ambiguity associated with legal standards would lead people to interpret legal standards in light of social norms. In contrast, the specificity of legal rules precludes such an interpretation and consequently strengthens the effectiveness of legal rules.", at 82).

would be rather inadequate to influence behavior in the case of lender control liability.

Geoffrey Miller makes a similar point, questioning the mixed message that directors in duty of care case receive, as normative or moralistic judicial commentary contradicts a decision refusing to impose liability.<sup>384</sup> Yet another criticism raised by Miller is more important: the liability rule will determine whether cases are brought and also whether those cases will be settled, altogether precluding moralistic commentaries.<sup>385</sup> As a result, the ability of judicial comments to influence the social norms dictating director or lender behavior in our case is grossly constrained.

A different argument against the usefulness of having a wedge between the standard of conduct and that of liability in lender control liability arises out the characteristic of one of the players. The distressed lending business is a rather complex endeavor which requires a fair amount of specific expertise. As a result, any lender is likely to have a team of lawyers repeatedly advising him about the legal ins and outs of DIP financing. Even if there was a more ambiguous standard governing lender control liability, the lender can be expected to learn how to gain influence without amounting to what the court would judge as control just from repeated playing. As a result, even with a standard of liability rather than a fixed rule, it is less likely that a social norm, in the way of a standard of conduct, will influence behavior the more information available about the standard of liability there is.<sup>386</sup> It follows that low powered incentives appear a priori inadequate to reduce a controlling lender opportunistic behavior.

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<sup>384</sup> See Geoffrey P. Miller "A Modest Proposal for fixing Delaware's Broken Duty of Care", *Columbia Business Law Review* 319, 329 (2010)

<sup>385</sup> See Geoffrey P. Miller "A Modest Proposal for fixing Delaware's Broken Duty of Care", *Columbia Business Law Review* 319, 329-30 (2010).

<sup>386</sup> See D. Gordon Smith "A Proposal to eliminate Directors Standards from the Model Business Corporation Act", 67 *University of Cincinnati L. Rev.* 1201, 1206-9 (1999).

## **VI. Conclusion**

It should be clear by now that allocating control to a lender in reorganization is not a neutrally efficient allocation. The central goal of this chapter has been to functionally analyze the ubiquitous problem of lender control by, first, tying it to modern economic understandings of what a firm is in order to pave the way for reestablishing a proper role for lender control liability theories. Lender control liability theories have largely fallen in disuse by United States courts. The implicit understanding of the theory of the firm by legal academics and courts has made it possible. Broadening the scope of the theory of the firm permits a better understanding that there is a role for lender liability theories besides mimicking the so called absolute priority rule.

This chapter has provided with an in-depth look into lender control liability theories. It has shown that lender control liability as currently understood is a non-deterrent to opportunistic behavior by controlling creditors. It has advanced the hypothesis that lender control liability's lack of bite is a result of understanding the firm in accordance with the explicit nexus of contracts theory. Additionally, it has shown that transaction by transaction focus of fraudulent conveyance law makes it an inadequate substitute to lender control liability. Finally, even if lender control liability was understood as a decision rule acting in conjunction with a conduct rule, as currently stated lender control liability is an improper vehicle to influence behavior in a desirable manner due to the characteristics of the standard of liability and the players repeated involvement in these matters. The next chapter will look into the practical problems that lender control liability application would run into when using a broader understanding of the theory of the firm. Specifically, the next chapter will address

problems generated by cognitive biases, namely hindsight bias and anchoring, in assessing lender liability.

## **Cognitive Errors and Lender Control Strict Liability**

### **I. Introduction**

In first two chapters of this dissertation, I have focused on the advantage of using economic theories of the firm to understand what problems may arise from lender control in business reorganization settings. Using a theoretical framework borrowed from economic theories of the firm, I have advanced two central points. First, I have shown that lender control may generate inefficiencies when some claims are not legally recognized, regardless of the existence of more than one class of legal claimants. This is important both because of the potential cumulative size of those claims and because they are potentially ubiquitous. Second, I have shown that the current use of the explicit nexus of contracts to inform lender control liability decisions renders lender control liability incapable of preventing instances of creditor opportunistic misbehavior. As a corollary to the later argument, I have shown that the current state of affairs cannot be a consequence of a mere substitution of lender control liability by fraudulent conveyance law, because the later is incapable of capturing an important number of lender misbehavior situations which should be covered by the former.

Analyzing the theoretical feasibility of obtaining better outcomes by the introduction of lender control liability is incomplete to claim its practical desirability. Indeed, even though more plausible theories of the firm open up the prospect of using lender control liability to limit opportunistic behavior, other arguments suggest the

need to exercise great caution. Arguments questioning individual rationality<sup>387</sup> could be suggested in order to impede the use of lender control liability. Specifically, lender control liability may need to be constrained if adjudicating problems due to cognitive errors are large enough to obstruct a proper achievement of its purpose. Hindsight bias has been signaled as one cognitive error important enough to impose limits in the application of lender control liability.

This chapter will attempt to start a discussion on the feasibility of obtaining first best outcomes by looking at problems produced by cognitive errors on adjudications of lender control liability. Specifically, in this chapter, I will discuss the standard of liability applicable to a lender in control and its relation to cognitive errors. The ordinary understanding of lender control liability considers it to be bad because it can trigger harmful strict lender liability. Therefore, lender control liability should be heavily limited or even suppressed so that the efficient lending is not precluded.<sup>388</sup> I will argue that this interpretation would be incorrect if the cognitive problem was caused by hindsight bias only, as the strict nature of lender control liability would avoid inefficiencies deriving from this bias.

Unfortunately, hindsight bias is not the only cognitive error potentially distorting judicial adjudications. A closer look at anchoring's role in damage assessments, permits to refocus policy recommendations and help explain the shortcomings of strict liability in this context. I will advance that the same cognitive errors that distort judicial adjudications arising in the case of lender control liability come up in the case of breaches of fiduciary duties by managers or directors, limiting

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<sup>387</sup> See, for instance, Paul Slovic "The Construction of Preference", 50 *Am. Psychol.* 364, 364-6 (1995), for a discussion of invariance attacks to rationality.

<sup>388</sup> See, for example, *In The Matter of Mobile Steel Company*, 563 F2d 692 (3<sup>rd</sup> Circuit, 1977)

also the debiasing effect of a strict liability rule in that context.

This chapter proceeds as follows. Part II shows that commonly voiced fears of adjudication errors due solely to hindsight bias in the context of lender control liability theories are unwarranted if the applicable standard is strict liability. Part III shows that policy oriented recommendations geared towards lender control liability should focus not only on hindsight bias but also on anchoring. The later conclusion follows from the fact that both the likelihood of the risk *and* the size of the damages require estimation. Part IV will succinctly provide some concluding remarks.

## **II. Cognitive Errors tainting adjudication accuracy**

### **A. Arguments against (strict) lender control liability**

A common argument against lender control liability comes from the perils of unevenly heard cases, by both juries and judges. There is a general level of uneasiness associated to possible deficiencies in adjudicators' abilities. This uneasiness gets especially noticeable when the subject matter of their decision is business decision making.<sup>389</sup> Strategic business decision making requires managers to

“[A]ssimilate large amounts of information about their own organization, the environments in which they do or might operate, and possible actions of their competitors, allies, and regulators.”<sup>390</sup>

At the same time, managers are required to “generate projections about future states of those matters and formulate plans.”<sup>391</sup> Due to the complexity of the task at hand it is

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<sup>389</sup> There's no reason to believe that adjudicating errors in other areas of law would be less problematic.

<sup>390</sup> See Ed Bukszar & Terry Connolly “Hindsight Bias and Strategic Choice: Some Problems in Learning from Experience”, 31 The Academy of Management Journal 628, 628 (1988).

<sup>391</sup> See Ed Bukszar & Terry Connolly “Hindsight Bias and Strategic Choice: Some Problems in Learning from Experience”, 31 The Academy of Management Journal 628, 628 (1988) (“Regardless of the particular model chosen, it is clear that strategic decision making is a dauntingly difficult intellectual task”).



feared, especially business oriented individuals, that adjudicators won't be able to correctly understand the decision making process or something akin to it due to the adjudicators' lack of expertise on the matter. Besides the lack of expertise, and maybe working together with it, there's the additional problem that the adjudicator may incur in systematic errors when facing an assessment which concerns the appropriateness of past decisions.<sup>392</sup> Both of these problems may generate liability for managers, directors or even controlling parties and therefore may disincentive appropriate levels of risk taking, or even participation from the individuals with the best aptitudes and/ or qualifications. The former criticism, i.e. lack of knowledge or at least familiarity with business decision making, seems largely limited by the specificity of bankruptcy courts' jurisdiction and the continuous stream of business bankruptcy cases that they face.<sup>393</sup> The later problem, usually assumed to be generated by hindsight bias, appears untamed and seems to remain strong.

The risks from opinions tainted with hindsight bias have been understood as especially harmful when they appear in connection with the strict character of lender control liability. Sharp criticism has naturally followed. For example, Hynes believes that it creates a dilemma for a controlling creditor:

“The more critical the financial condition of a business, the more control the creditor will want to assert in an effort to keep the business in a state of solvency and thus able to repay its debts. Yet the more

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<sup>392</sup> For an example of concern over hindsight bias in the business setting, see *In The Matter of Mobile Steel Company*, 563 F2d 692, 702-3 (3<sup>rd</sup> Circuit, 1977) (“Absolute measures of capital inadequacy, such as the amount of stockholder equity or other figures and ratios drawn from the cold pages of the corporation's balance sheets and financial statements, are of little utility, for the significance of this data depends in large part upon the nature of the business and other circumstances. Nor is the fact of eventual failure an appropriate test. This would be tantamount to ruling that an investor who takes an active role in corporate affairs must advance to his corporation all of the funds, which hindsight discloses it needed to survive.”)

<sup>393</sup> The fairly constant flow of cases asking from bankruptcy courts to deal with distress business decision making increases the probability of adequate evaluations of those decisions.

control the creditor asserts, the greater risk it runs under the common law of agency of incurring personal liability for the debts of the business”.<sup>394</sup>

The strict character of lender control liability first appeared in section 14 O of the Restatement Second of the Law of Agency,<sup>395</sup> which stated

“A creditor who assumes control of his debtor’s business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business.”<sup>396</sup>

The Restatement Third of the Law of Agency has dropped section 14 O, but the doubts remain on whether lender control still possesses a strict liability character.

In addition to the fears arising from improper adjudication, the supporters of limiting lenders’ liability also look into comparisons with directors and managers liability under the so called business judgment rule (BJR) to contrast the latter to a strict lender control liability rule.<sup>397</sup> If under BJR a director or manager is not liable

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<sup>394</sup> See J. Dennis Hynes “Lender Liability: The Dilemma of the Controlling Creditor”, 58 Tenn. L. Rev. 635, 637-8 (1991). Hynes’ understanding of the lender liability problem is centered on agency costs, relying on the famous phrase of Justice Learned hand in *Admiral Oriental Line v. United States* expressing that “The doctrine stands upon the fact that the venture is the principal’s, and that, as the profits will be his, so should be the expenses.” See *Admiral Oriental Line v. United States*, 86 F.2d 201, 202 (Second Circuit, 1936).

<sup>395</sup> See Section 14 O, Restatement Second of the Law of Agency (1958). The second edition was published in 1958. The first edition of the Restatement, published in 1933, contains no reference to the topic addressed in Section 14 O. Hynes mentions that “No case or statutory authority from the 25-year period of time between the editions has been uncovered that would account for the promulgation of Section 14 O.” See J. Dennis Hynes “Lender Liability: The Dilemma of the Controlling Creditor”, 58 Tenn. L. Rev. 635, 637-8 (1991).

<sup>396</sup> See Section 14 O, Restatement Second of the Law of Agency (1958).

<sup>397</sup> For a definition of the business judgment rule, see Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 U. Chi. L. Rev. 571, 619 (1998), citing American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §4.01(c) at 177-78 (ALI 1991) (“an officer or director who is informed about a transaction being undertaken by the corporation, and is not an interested party in the transaction, “fulfills his duty [of care to the shareholders] if...he rationally believes that his business judgment is in the best interests of the corporation.”)

unless there's evidence of some sort of gross negligence, then imposing strict liability on a controlling lender would be strikingly inconsistent for individuals having similar decision making roles.

## **B. Hindsight Bias**

In order to assess these judgments against the lender control liability, it is necessary to say something more about cognitive errors in general and specifically about hindsight bias. Cognitive errors are patterns of deviation in judgment thought to be produced by mental shortcuts which in turn “can create [the] cognitive illusions that produce erroneous judgments.”<sup>398</sup> Among those errors, hindsight bias occurs when

“[p]eople overstate their own ability to have predicted the past and believe that others should have been able to predict events better than was possible.”<sup>399</sup>

Hindsight bias is often referred to as the “knew-it-all-along” effect.<sup>400</sup> The occurrence of hindsight bias seems to suggest that “in retrospect, people see the world as unfolding inevitably toward the present.”<sup>401</sup>

Psychologists explain hindsight bias as arising “primarily from the natural (and

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<sup>398</sup> See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “ Inside the Judicial Mind”, 86 Cornell L. Rev. 777, 780 (2001)

<sup>399</sup> See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “ Inside the Judicial Mind”, 86 Cornell L. Rev. 777, 799 (2001) (“the hindsight bias consists of using known outcomes to assess the predictability at some earlier time of something that has already happened”). See, also, Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort “Fraud by Hindsight”, 98 Nw. U.L. Rev. 773, 774 (2004) (“People consistently overstate what could have been predicted after events have unfolded... Consequently, they blame others for failing to have foreseen events that reasonable people in foresight could not have foreseen”)

<sup>400</sup> See Lawrence J. Sanna “Metacognitive Experiences and Hindsight Bias: It’s not just the Thought (Content) that Counts”, 25 Social Cognition 185, 186 (2007); Tarek El-Sehitya, Hans Haumerb, Christian Helmensteinc, Erich Kirchlerd & Boris Maciejovsky “Hindsight Bias and Individual Risk Attitude within the Context of Experimental Asset Markets”, 4 Journal of Behavioral Finance 227 (2002).

<sup>401</sup> See Ed Bukszar & Terry Connolly “Hindsight Bias and Strategic Choice: Some Problems in Learning from Experience”, 31 The Academy of Management Journal 628, 630 (1988)

useful) tendency for the brain to incorporate known outcomes into existing knowledge automatically, and to make further inferences from that knowledge.”<sup>402</sup> There are two competing hypotheses of how the new information is integrated. One of them assumes

“[T]hat outcome information will impair automatically and unconsciously association strengths or cue values stored in memory, thus resulting in a biased numerical estimate or choice in hindsight.”<sup>403</sup>

The other hypothesis consists in

“[A]ssuming that hindsight bias is due to a *biased reconstruction* of the original estimate rather than to an impaired memory.”<sup>404</sup>

Understanding how new information generates hindsight bias is important, among other things, to evaluate whether it is a product of self-serving judgments.

In order to demonstrate the phenomenon, researchers have conducted numerous studies with either a memory or a hypothetical design.<sup>405</sup> In the former, the participants of the study are first asked to produce an estimate of a future outcome, then are presented with the actual outcome and later on are asked to remember their answer as if they didn’t know about the outcome.<sup>406</sup> The second type of study presents a group of participants with information about an outcome and asks them to estimate the probability of its occurrence while a control group is also asked to estimate the probability of occurrence but without being informed about the outcome. While

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<sup>402</sup> See Jeffrey J. Rachlinski “Heuristics and Biases in the Courts: Ignorance or Adaptation?”, 79 Or. L. Rev. 61, 68 (2000).

<sup>403</sup> See Gaelle Villejoubert “Could They Have Known Better? Review of the Special Issue of Memory on the Hindsight Bias”, 19 Applied Cognitive Psychology 140, 142 (2005).

<sup>404</sup> See Gaelle Villejoubert “Could They Have Known Better? Review of the Special Issue of Memory on the Hindsight Bias”, 19 Applied Cognitive Psychology 140, 142 (2005).

<sup>405</sup> See Gaelle Villejoubert “Could They Have Known Better? Review of the Special Issue of Memory on the Hindsight Bias”, 19 Applied Cognitive Psychology 140, 140 (2005).

<sup>406</sup> The first example of this comes from the work of Fischhoff and Beyth. See Baruch Fischhoff & Ruth Beyth “‘I Knew It Would Happen’ – Remembered Probabilities of Once Future Things”, 13 Organizational Behavior and Human Performance 1 (1975).

hindsight bias has been extensively found using both approaches, study design invariance is questioned by researchers.<sup>407</sup>

Regardless of the mechanism originating the bias and the elicitation method, hindsight bias appears to be an omnipresent and very resistant human characteristic.<sup>408</sup> Kamin and Rachlinski report the persistency of the effect despite numerous debiasing attempts.<sup>409</sup> Kamin and Rachlinski mention that

“Unfortunately, the hindsight bias has proven resistant to most debiasing techniques... Some researchers have obtained limited debiasing by significantly restructuring the decision-making task, or by having participants consider alternative outcomes. Although these cognitive strategies have reduced the influence of the bias, no known technique completely eliminates the effect.”<sup>410</sup>

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<sup>407</sup> See Tarek El-Sehitya, Hans Haumerb, Christian Helmensteinc, Erich Kirchlerd & Boris Maciejovsky “Hindsight Bias and Individual Risk Attitude within the Context of Experimental Asset Markets”, 4 *Journal of Behavioral Finance* 227, 240 (2002) (“Our results do not lend support to the conjecture that traders on an experimental asset market are prone to hindsight bias in remembering their price predictions. Moreover, the results indicate that hindsight bias does not appear to be generally present; rather it was found to be moderated by the methodology in use. This result may be content-specific. Whereas in studies with almanac questions hindsight bias seems to be a robust phenomenon, in our experimental approach personal experience and feedback on financial performance may crowd out the bias. Another explanation for our finding may be the within-subjects design itself, relating to an asymmetry in the possibility to draw upon prior information”).

<sup>408</sup> Rachlinski believes that the hindsight bias is so deeply ingrained in the judgment process that it is probably impossible to avoid its influence. See Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 *U. Chi. L. Rev.* 571, 602 (1998) (“Avoiding the influence of the hindsight bias altogether, however, is probably impossible. Because the bias is so deeply ingrained into the human judgment process, psychologists have been unable to develop a way to induce people to make unbiased ex post judgments of ex ante probabilities.”)

<sup>409</sup> See Kim A. Kamin & Jeffrey J. Rachlinski “Ex Post ≠ Ex Ante: Determining Liability in Hindsight”, 19 *Law & Hum. Behav.* 89, 92 (1995). Somewhat surprisingly, one study found no evidence of hindsight bias on judges’ determinations of probable cause. See Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 *U. Pa. L. Rev.* 1251, 1313-18 (2005). Sanna and Schwarz explain that “Hindsight biases emerge independent of judges’ expertise, accuracy motivation, or task importance.” See Lawrence J. Sanna & Norbert Schwarz “Debiasing the Hindsight Bias: The Role of Accessibility Experiences and (Mis)attributions”, 39 *Journal of Experimental Social Psychology* 287, 287 (2003).

<sup>410</sup> See Kim A. Kamin & Jeffrey J. Rachlinski “Ex Post ≠ Ex Ante: Determining Liability in Hindsight”, 19 *Law & Hum. Behav.* 89, 92 (1995).

It follows that the hindsight bias defies the proficiency of ex post judges to correctly distinguish between an irrational, merely suboptimal or self-interested decision vis-à-vis an unfortunate turn of events. Once this knowledge is applied to the context of lender opportunistic behavior, it naturally questions one of the main points raised in the previous chapter, namely the benefit of broadening the scope of lender control liability due to the risk of penalizing efficient decision making by controlling lenders.

As it was mentioned above, empirical studies in different contexts have confirmed the concerns regarding hindsight bias. Specifically, several studies have demonstrated that judges, including in particular bankruptcy judges, are also affected by several cognitive biases among which is the hindsight bias.<sup>411</sup> In addition, several opinions recognize the problem and express particular concern about adjudicators falling prey to the influence of hindsight bias, what leads them to avoid taking actions that would make them prone to cognitive errors.<sup>412</sup> A prominent example came from the Seventh Circuit opinion in *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting*, where Judge Easterbrook mentioned, in the context of an equitable subordination action, that

“Debtor submits that conduct may be “unfair” and “inequitable” for [the] purpose [of determining whether to apply equitable subordination] even though the creditor complies with all contractual requirements, but we are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do “more” -just how much more resting in the discretion of a bankruptcy

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<sup>411</sup> See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “ Inside the Judicial Mind”, 86 Cornell L. Rev. 777 (2001); Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Bankruptcy Judge’s Mind”, 86 B.U.L. Rev. 1227 (2006).

<sup>412</sup> Gulati, Rachlinski and Langevoort state that “Courts cite concerns with hindsight in nearly one-third of all published opinions in securities class action cases.” See Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort “Fraud by Hindsight”, 98 Nw. U.L. Rev. 773, 775 (2004).

*judge assessing the situation years later.*”<sup>413</sup>

In the same vein, the Delaware Chancery Court expressed in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, a case concerning the possible breach of fiduciary duties by a parent company directors towards the subsidiary’s creditors, that

“What Delaware law does not do is to impose retroactive fiduciary obligations on directors simply because their chosen business strategy did not pan out.”<sup>414</sup>

Other instances replicating the worry of hindsight bias affecting the objectiveness of assessments has also been brought out in the instructions that trial judges give to the jury when considering director’s liability. For instance, in *Theriot v. Bourg*, trial court’s instructions read

“[Y]ou should not evaluate defendants actions through insights and wisdom that you have gained only through hindsight. Likewise, you can not judge the wisdom of a business venture solely by its results. The mere fact that a loss was sustained does not prove that the business judgment was improvidently made.”<sup>415</sup>

The concern about hindsight bias shows that overcoming its problems is far from trivial. Nonetheless, there is a legal debiasing technique which has been

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<sup>413</sup> See *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356 (7<sup>th</sup> circuit, 1990) (emphasis added). Similarly, the Second Circuit affirmed that after the fact assessments may not be more than a wild hunch. See *Joy v. North*, 692 F.2d 880, 886 (2<sup>nd</sup> Circuit, 1982) (“Second, courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.”)

<sup>414</sup> See *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 173 (Del. Ch., 2006)

<sup>415</sup> See *Theriot v. Bourg*, 691 So. 2d 213, 220 (1<sup>st</sup> Circuit, 1997).

proposed as a way to avoid hindsight bias problems at least in the context of directors and managers liability assessments. The next subsection will discuss this proposed technique.

### C. Hindsight Bias and Strict Liability

Despite the sharp criticism voiced against liability judgments due to the fear of hindsight bias, Rachlinski has proposed a *debiasing*<sup>416</sup> legal tool in the case of managers' fiduciary liability.<sup>417</sup> Rachlinski proposes to eliminate hindsight bias by allocating the liability assessment before the action is taken. His proposal works as a way to reduce the problems presented by hindsight bias strictly for those cases where

“[T]he technology of precaution is unilateral (in the sense that only the potential injurer can realistically take action to reduce the probability or severity of an accident)”.<sup>418</sup>

Theoretically, strict liability insulates injurers from the possibility of hindsight bias because the party who may potentially damage another assesses the situation *ex ante*. As the potential tortfeasor is always found liable because negligence plays no role in the process, then he doesn't have to pay attention to *ex post* determinations of probabilities.<sup>419</sup>

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<sup>416</sup> It is slightly inaccurate to refer to strict liability as debiasing device, as having strict liability avoids *ex post* assessments and therefore avoids hindsight rather than debiasing it once it already occur. I will nonetheless use it in order to maintain the current terminology.

<sup>417</sup> See Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 U. Chi. L. Rev. 571, 595-600 (1998)

<sup>418</sup> In fact, Korobkin and Ulen propose to increase the use of strict liability as a way to limit the effect of hindsight bias. See Russell B. Korobkin & Thomas S. Ulen “Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics”, 88 Calif. L. Rev. 1051, 1098-9 (2000)

<sup>419</sup> The idea of letting the possible tortfeasor evaluate the probability of harm *ex ante* and therefore avoid bias is closely related to the use of an *ex ante* custom to avoid judgments biased by hindsight, as for example in the cases of medical malpractice. See Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 U. Chi. L. Rev. 571, 612 (1998) (“In one class of cases--medical malpractice--courts have acknowledged that the profession's *ex ante* custom is probably superior to their *ex post* judgment. Doctors who have followed customary medical procedure are not to be considered negligent. The courts believe that the conditions necessary for the development of efficient customs exist in the medical profession. This exception to the general rule shows that the courts do distrust the value of second-guessing *ex ante* decisions. However, there are reasons other than the hindsight bias to



To better understand Rachlinski's argument, it is convenient to look at the standard tort model used in law and economics for those cases where the technology of precaution is unilateral.<sup>420</sup> In that model, there are two variables: the potential injurer's activity level  $z$  (chosen by injurers) and the level of care  $x$  which he can opt to engage in. The activity level will generate benefit  $b(z)$  and the level of care will generate a probability of harm  $p(x)$ . In addition, it is assumed that  $x$  represents the private cost to a potential injurer arising from prevention and that  $h$ , a fixed value, represents the possible damage caused by the injurer each time an injurer engages in his activity. Then, in order to promote a Kaldor- Hicks type of efficiency, the social objective would be to maximize

$$b(z) - z(x + p(x)h) \quad (1)$$

Standard law and economics arguments go on to suggest that wealth maximization, in this case represented by maximization of (1), should be the main objective the tort legal system should try to achieve.<sup>421</sup>

Following this model, a legal system would be more efficient and, arguably, a potential injurer choosing behind the veil of ignorance<sup>422</sup> would prefer to be judged by strict liability when there's a possibility of hindsight bias, as a strict liability system erases the possibility that adjudicators ex post determine that the level of care the

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treat a medical custom as reasonable per se. The medical profession has more expertise than the courts at determining appropriate treatments and has sufficient economic incentives to develop customs that reflect due care. The inaccuracy of judging in hindsight is yet another strike against the institutional competence of the courts.")

<sup>420</sup> See Steven Shavell "Strict Liability Versus Negligence", 9 J. Legal Stud. 1 (1980)

<sup>421</sup> See Daniel Brudney "Hypothetical Consent and Moral Force", 10 Law and Philosophy 235, 235-7 (1991).

<sup>422</sup> See Daniel Brudney "Hypothetical Consent and Moral Force", 10 Law and Philosophy 235, 238 (1991) ("The argument is simply that ex ante she would have consented to the [social wealth maximization] policy as in her individual interest. As a rational agent she would have preferred it. Therefore, ex post, it ought to be imposed on her.")

injurer chose generated a probability of harm  $\tilde{p}(x)$  larger than it actually did - i.e.  $\tilde{p}(x) > p(x)$  -.<sup>423</sup> The potential injurer will know ex ante the values of  $x$ ,  $p(x)$  and  $h$ , while at the same time the potential injurer knows that the assessment of  $h$  will be accurate.<sup>424</sup> Therefore, the potential injurer will maximize (1) without the need to pay attention to anything else. Hence, and regardless of the distributive effects that strict liability would carry, strict liability would assure that efficient activity and care levels are taken irrespective of any hindsight bias impact.<sup>425</sup>

Even when the technology of precaution is unilateral, it doesn't necessarily follow that strict liability should be applied to liability assessments against managers or controlling parties (as lenders) as a way to prevent adjudication errors due to hindsight bias. In some contexts, Rachlinski believes that it may not be efficient to adopt a strict liability rule. Focusing on the BJR, Rachlinski considers that while it works as a "no liability" rule it is as an efficient way to achieve a second best<sup>426</sup> in dealing with hindsight bias.<sup>427</sup> Obviously, a no-liability regime impedes hindsight bias

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<sup>423</sup>  $\tilde{p}(x)$  is the ex post probability assessment tainted by hindsight bias. Because hindsight would turn  $p(x)$  into  $\tilde{p}(x)$ , it follows that a negligence rule would make the potential tortfeasor maximize  $b(z) - z(x + \tilde{p}(x)h)$ , which means that the activity level will never be higher than under strict liability.

<sup>424</sup> This follows from the model assumption. In the case of an accident, the proto-typical example in mind when the model was developed, it is fair to assume that there won't be a major problem in the assessment of damages. For example, if someone crashes his vehicle into a mailbox destroying the latter, the money required to replace the mailbox will be easily assessed after checking the market price for mailboxes. In the case of lender control liability and the business judgment rule it is not clear that the amount of damages can be assessed in such a clear way. I will go back to this point in section III.

<sup>425</sup> Nonetheless, Rachlinski argues that even if negligence is the standard used to assess liability social efficiency may not be substantially affected, as lenders will understand the negligence standard as a quasi-strict liability one. See Jeffrey J. Rachlinski "A Positive Psychological Theory of Judging in Hindsight", 65 U. Chi. L. Rev. 571, 595-600 (1998) ("the hindsight bias converts the negligence standard into a de facto system of strict liability. Negligence judgments influenced by the hindsight bias should therefore have economic consequences similar to those of a system of strict liability.")

<sup>426</sup> On the theory of second best, see Richard G. Lipsey & Kelvin Lancaster "The General Theory of Second Best", 24 Review of Economic Studies 11 (1956).

<sup>427</sup> See Jeffrey J. Rachlinski "A Positive Psychological Theory of Judging in Hindsight", 65 U. Chi. L. Rev. 571, 619 (1998) ("have fewer adverse consequences than a rule of negligence judged in hindsight"). Jolls and Sunstein believe that this type of debiasing rules are of an invasive character, as entirely block choice in the hope that legal outcomes will not fall prey to problems of bounded rationality and recommend the adoption of a less intrusive method. See Christine Jolls & Cass R. Sunstein "Debiasing through Law", 35 J. Legal Stud. 199, 202 (2006) ("Compared with the more

as the later can only arise when an ex post assessment is made. Rachlinski provides both “equitable and economic” reasons to use a no-liability rule in the case of the BJR. The later arguments refer to the disincentive that a strict liability rule would create on people to become firm’s managers, as well as the incentives to take excessive precautions a liability rule would create for the individuals who take on a managing activity. As a result, general economic activity would be undermined.<sup>428</sup> The former arguments focus on shareholders’ ability to fire managers directly or indirectly by selling their stock, the limited amount of loss suffered by shareholders and their ability to diversify their risk of loss. Therefore, Rachlinski believes that a no-liability BJR prevents the costs of having suboptimal managers, as well as the chance that they choose only low risk projects, while at the same time complementary rules allow to limit the costs that managers’ misbehavior can impose on individual shareholders.

To the extent that Rachlinski’s view can be used as an analogy for lender control liability, it vindicates Section 14 O of the Restatement Second of the Law of Agency and calls into question the benefit of dropping such clause. In the following section, I will look into another cognitive problem, anchoring, to further investigate the benefit from having a strict liability rule for lender control liability, as well as for directors and/ or managers fiduciary duties. In section III, I will discuss whether a no-liability rule is a good alternative also in the context of lender control liability.

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common approach of insulating legal outcomes from the effects of bounded rationality, a significant advantage of strategies for debiasing through law is that they aim to correct errors while still preserving as much opportunity as possible for people to make their own choices... An important corollary of choice-preserving strategies is that they help to address boundedly rational behavior while avoiding the imposition of significant costs on those who do not exhibit bounded rationality.”)

<sup>428</sup> See Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 U. Chi. L. Rev. 571, 622-3 (1998)

#### D. Anchoring

Closely related to hindsight bias, another well-known cognitive error is commonly referred to as anchoring.<sup>429</sup> Tversky and Kahneman define anchoring as the bias which occurs when people make estimates depending on an irrelevant starting point.<sup>430</sup> Guthrie, Rachlinski and Wistrich consider that

“[a]nchors affect judgment by changing the standard of reference that people use when making numeric judgments.”<sup>431</sup>

As well as hindsight bias, anchoring is intimately related to the difficult problem of disregarding known information.<sup>432</sup> Wistrich, Guthrie and Rachlinski provide three theories to help explain this phenomenon based on motivation, ironic process theory and mental contamination.<sup>433</sup> The first theory, motivation, implies that explicitly telling people to disregard information may increase their desire to attend to it, a concept researchers refer to as “psychological reactance”. The second theory, ironic process, suggests that even if individuals want to ignore certain information, they may find particularly difficult to avoid thinking about *that* information they *do* want to ignore. Finally, mental contamination theory puts forward that the brain does not compartmentalize gathered information. As a result, information which may be irrelevant to this decision may, nonetheless, affect individual’s judgment by

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<sup>429</sup> See Nicholas Epley & Thomas Gilovich “The Anchoring-and-Adjusting Heuristic: Why the Adjustments Are Insufficient”, 17 *Psychological Science* 311 (2006).

<sup>430</sup> See “Judgment Under Uncertainty: Heuristics and Biases”, in *Judgment Under Uncertainty: Heuristics and Biases*, Daniel Kahneman, Paul Slovic, & Amos Tversky eds., Cambridge University Press, New York, NY (1982), p. 14. In the same vein, Epley and Gilovich consider that “the starting information, or anchor, tends to exert a drag on the subsequent adjustment process, leaving final estimates too close to the original anchor.” See Nicholas Epley & Thomas Gilovich “The Anchoring-and-Adjustment Heuristic: Why the Adjustments are Insufficient?”, 17 *Psychological Science* 311, 311 (2006).

<sup>431</sup> See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 *Cornell L. Rev.* 777, 788 (2001)

<sup>432</sup> See Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 *U. Pa. L. Rev.* 1251, 1260-70 (2005)

<sup>433</sup> See Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 *U. Pa. L. Rev.* 1251, 1260-70 (2005)

influencing how subsequent events are processed and which beliefs are formed.

Regardless of which theoretical reflection best describes the existence of anchoring, this bias has been empirically observed in many diverse fields.<sup>434</sup> Specifically relating to the focus of this paper, Guthrie, Rachlinski and Wistrich have produced three separate demonstrations of anchoring, showing that it affects federal magistrates, state and federal judges, and bankruptcy judges.<sup>435</sup> The first among these studies was conducted over a sample of federal magistrate judges who were asked to assess damages arising out of an accident. Guthrie, Rachlinski and Wistrich found that their sample group was subject to anchoring,<sup>436</sup> despite the fact that “judges are experienced, well-trained, and highly motivated decision makers”.<sup>437</sup> In the second study, based on a similar damage assessment case, a sample of federal magistrates, state and federal judges were exposed to anchoring effects arising from both low and high anchors. As expected, Guthrie, Rachlinski and Wistrich found that both anchors had a significant impact on the amount of damages awarded. In the third study, bankruptcy judges faced a determination of interest rate in a chapter 13 case.

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<sup>434</sup> Ariely, Loewenstein and Prelec asked MBA students whether they would buy some products for a price equal to the dollar figure equivalent to the last two digits of their social security number. Afterwards, they were asked to specify the highest amount they would be willing to pay for the products while reminded that the social security number is random. The subjects with higher social security numbers were willing to pay more for the products. See Colin F. Camerer & George Loewenstein “Behavioral Economics: Past, Present, Future”, in *ADVANCES IN BEHAVIORAL ECONOMICS*, Colin F. Camerer, George Loewenstein & Matthew Rabin eds., Princeton University Press, Princeton, NJ (2004), p. 13., citing Dan Ariely, George Loewenstein & Drazen Prelec “Coherent Arbitrariness: Stable Demand Curves without Stable Preferences”, 118 *Quarterly Journal of Economics* 73 (2003). For another example regarding underwriters recommendations, see Roni Michaeli & Kent L. Womack “Market Efficiency and Biases in Brokerage Recommendations”, in *Advances in Behavioral Finance*, Richard H. Thaler ed., Princeton University Press, Princeton, NJ (2005), p. 408.

<sup>435</sup> See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 *Cornell L. Rev.* 777, 780 (2001); Andrew J. Wistrich, Chris Guthrie & Jeffrey J. Rachlinski “Can Judges Ignore Inadmissible Information? The Difficulty of Deliberately Disregarding”, 153 *U. Pa. L. Rev.* 1251 (2005); and, Jeffrey J. Rachlinski, Chris Guthrie & Andrew J. Wistrich “Inside the Bankruptcy Judge’s Mind”, 86 *B.U.L. Rev.* 1227 (2006).

<sup>436</sup> See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 *Cornell L. Rev.* 777, 787-94 (2001).

<sup>437</sup> See Chris Guthrie, Jeffrey J. Rachlinski & Andrew J. Wistrich “Inside the Judicial Mind”, 86 *Cornell L. Rev.* 777, 782 (2001)

Although, the results were relatively smaller, anchoring still had a noticeable impact on the outcome. It is not immediately clear why bankruptcy judges were relatively less prone to the cognitive error in this study. Rachlinski, Guthrie and Wistrich believe that they aren't less susceptible to this effect.<sup>438</sup>

Although anchoring has been found in different contexts, researchers have found ways to affect its magnitude. Anchoring produced by declarative information has been shown to be negatively affected by the interplay of metacognitive experiences, such as

“[P]articipants provided estimates closer to self-generated anchors (i.e., they adjusted less) when they were simultaneously nodding their heads up and down (consistent with acceptance...) than when they were shaking their heads from side to side (consistent with rejection).”<sup>439</sup>

In addition, anchoring has been shown to be negatively correlated to the confidence the evaluator has in its own assessment (i.e. “when people are not confident in their judgments, they are more susceptible to anchoring effects”), a confidence which Sunstein, Kahneman and Schkade believe to be low when awarding dollar amounts.<sup>440</sup>

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<sup>438</sup> See Jeffrey J. Rachlinski, Chris Guthrie & Andrew J. Wistrich “Inside the Bankruptcy Judge’s Mind”, 86 B.U.L. Rev. 1227, 1233-37 (2006) (“In the first of these studies, we showed that the introduction of an extremely low anchor reduced damage awards by 0.41 standard deviations. In the second study, we tested the effects of both a low and a high anchor and found that the low anchor reduced awards by 0.58 standard deviations, while the high anchor increased awards by 0.75 standard deviations. In the present study of bankruptcy judges, the anchor increased the interest rate by 0.37 standard deviations. The effect size observed in this study is only slightly smaller than the effect size we have observed in our previous studies of generalist judges. Therefore, we cannot conclude from this that bankruptcy judges are less susceptible than generalist judges to the anchoring effect”)

<sup>439</sup> See Nicholas Epley & Thomas Gilovich “The Anchoring-and-Adjusting Heuristic: Why the Adjustments Are Insufficient”, 17 Psychological Science 311, 312 (2006), citing Nicholas Epley & Thomas Gilovich “Putting adjustment back in the anchoring and adjustment heuristic: Differential processing of self-generated and experimenter-provided anchors”, 12 Psychological Science 391 (2001)

<sup>440</sup> See Cass R. Sunstein, Daniel Kahneman and David Schkade “Assessing Punitive Damages (with Notes on Cognition and Valuation in Law)”, 107 Yale L. J. 2071, 2109 (1998).

In the next section, I will explore the possibility of anchoring and hindsight bias acting together and affecting ex post assessments. To the best of my knowledge, there has not been any study yet connecting anchoring, in addition to hindsight bias, to lender control liability theories or the BJR.

### **III. Damage Assessments: the Role of Anchoring**

What is the relation between anchoring and hindsight bias? If both cognitive errors were to act together, then it would question whether a strict liability rule is an efficient way to limit biases in ex post adjudications. If that was the case, and regardless of whether Rachlinski's BJR analysis could be extended to lender control liability,<sup>441</sup> the inability to trust adjudicators on liability assessments would not merely be due to hindsight bias but also to anchoring. If this was the case, this analysis would apply analogously to the BJR context.

#### **A. Lender Control Liability: The Interplay of Anchoring and Hindsight Bias**

I will suggest that where lender control liability theories are involved, the superior characteristic of strict liability in unilateral torts doesn't apply because damage determinations are difficult to establish and are also prone to cognitive errors (i.e. anchoring). As it was explained above, in the standard unilateral tort model used

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<sup>441</sup> The "equitable" reasons provided by Rachlinski do not seem compelling for lender control liability on firms formed partially with implicit contracts. First, as stock is not the only way to participate in the "ownership" of the firm, then voting control has a limited disciplining power. In addition, because the firm is in distress selling the stock (or claims) to sanction a controlling lender would have a very limited effect (if any at all). Second, if there are firm specific investments, the magnitude of the loss could be higher (i.e. in lost wages) than what was invested, frustrating for these actors the limited liability of corporations. Third, firm specific investments are not easily diversifiable (i.e. you can't make large numbers of firm specific investments). The "economic" reasons may not deter a controlling lender. It is not clear what comprises excessive precautions. As lender control liability can potentially generate costs which are externalized to other constituents, it is not clear that today the optimal level of precautions is taken. I leave the resolution of these issues for future research.

in law and economics the level of damages is entirely independent from the level of care exercised by the potential injurer and, more importantly, it is assumed that the level of harm is fixed whenever an accident occurs. The later simplifying assumption makes sense when we discuss damages arising from accidents, where the amount of damages is fairly easy to establish and can generally be thought to be a product of the level of care exercised by the potential injurer. For example, in the case of an out of control car running into a fence and destroying it, the amount of money required to make the owner of the fence even is easily established by checking the market price for the materials and labor required to reconstruct the fence. In those situations where damages assessments require counterfactual inquiries, as with lender control liability cases, the possibility of falling prey to cognitive errors shows that thinking of damages as fixed amounts may be counterproductive. Indeed, the amount of damages won't likely be a product of the potential injurer's level of care, but rather a product of the potentially biased assessment by the adjudicator.

An example, concentrating on the size of the damage determination, will help to illustrate the later point.<sup>442</sup> I will put aside the complex questions of whether the lender was in control or not in order to merely focus on the amount of the damage assessment.<sup>443</sup> Let's assume for simplicity that a controlling lender of a reorganizing firm has two options<sup>444</sup>: he can either liquidate the firm, generating a fixed amount  $L$ , or he can attempt to reorganize it. If he chooses the latter, he will incur for sure

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<sup>442</sup> This example follows what Fischel calls a familiar pattern in lender liability cases. See Daniel R. Fischel "The Economics of Lender Liability", 99 Yale L. J. 131, 147 (1989) ("Damage claims in lender liability cases follow a familiar pattern. A lender is alleged either to have wrongfully refused to lend, or to have called, a loan. The borrower then demands huge actual damages based on lost profits.")

<sup>443</sup> A proposal on how to assess whether a lender is in control or not will be given in the next chapter. For now, it is assumed that it is evident whether a lender is in control or not.

<sup>444</sup> In this example, I am assuming that there are no problems emerging from different classes of legal claimholders and that relationship specific investments are not affected by the decision. Although I recognize the unrealistic nature of these assumptions, using them will help us to focus on why strict liability cannot help to insulate against the hindsight bias.



reorganization costs  $C$ . These costs may derive from several different sources, such as negotiation costs, the costs of running the firm until a plan is approved, the costs of *lost* managerial energies, etc. Let's further assume that if the reorganization option is chosen, the firm may obtain a favorable reorganization value  $R^+$  with a probability  $p(R^+)$  or, alternatively, an unfavorable reorganization value  $R^-$  with probability  $p(R^-)$ . Therefore, a controlling lender willing to maximize firm value<sup>445</sup> and deciding on a course of action under a strict lender control liability rule should choose, in a cognitive error free scenario, depending on whether  $L$  is bigger or smaller than

$$R^+ * p(R^+) + R^- * p(R^-) - C \quad (2)$$

Unfortunately, this is not a cognitive error free world. Let's assume then, that if the controlling lender chooses option  $L$ , the state of the world that realizes is the favorable one where an independent adjudicator having to assess the propriety of the liquidation option will have to infer the value or range of values which would have realized if the reorganization option was chosen. Finally, let's assume that as a result of the realized state of the world the controlling lender gets sued under lender control liability under the theory that the rest of the claimholders were prejudiced due to the *clearly* (or even knowingly) mistaken liquidation decision. How will the adjudicator likely proceed in order to resolve this dispute?

In order to determine whether the controlling lender liquidation decision was detrimental to the other claimants the adjudicator will need to investigate the existence of damage, which by assumption is traceable to the controlling lender's decision. To

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<sup>445</sup> It is unlikely that a controlling lender who gets control through covenants in the debt contract and having a security interest in most, if not all, of the debtor assets will choose following (2), as he would prefer to maximize a sure return over a risky one. Nonetheless, in order to simplify the analysis I will abstract away from this issue and assume that the controlling lender will be "altruistic".

accomplish the damage evaluation, the adjudicator needs to compare  $L$ , which is assumed to have been obtained in a fair process, with his assessment of the ex ante result of reorganization. If the adjudicator was cognitive error free, the answer would be given by (2). Provided that the reorganization estimate is bigger than the liquidation value, then the controlling lender could potentially have to pay damages up to that difference.<sup>446</sup> As  $L$  is fixed by whatever amount was obtained in the liquidation of the firm's assets, then the damage assessment will depend on the estimated value of the counterfactual reorganization.

For an adjudicator to determine the reorganization value, three set of quantities need to be estimated: the probabilities of each state of the world occurring, the costs of restructuring and the reorganization value in each of the possible states of the world. It is safe to assume that courts can estimate rather accurately restructuring costs due to their extended experience with this type of cases. In addition, there is a fairly important number of empirical papers describing a consistent range of mean and median direct, and even indirect, bankruptcy costs.<sup>447</sup> The potentially problematic issue is to determine the assessments of probabilities, as well as reorganization values.

It is fair to assume, as we have seen before, that probabilities would likely be overestimated due to hindsight bias. Again, strict liability would prevent a controlling

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<sup>446</sup> We are abstracting away from any damages occurring out reliance in the behavior or words of the controlling lender.

<sup>447</sup> See Edward I. Altman "A Further Empirical Investigation of the Bankruptcy Cost Question", 39 *Journal of Finance* 1067 (1984); Robert A. Haugen & Lemma W. Senbet "The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure", 33 *Journal of Finance* 383 (1978); Arturo Bris, Ivo Welch & Ning Zhu "The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization", 61 *Journal of Finance* 1253 (2006); Maria Carapeto "Is Bargaining in Chapter 11 Costly?", Cass Business School Working Paper, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=241569](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=241569) (2003); and, Robert M. Lawless & Stephen P. Ferris "Professional Fees and Other Direct Costs in Chapter 7 Business Liquidations", 75 *Wash. U. L. Q.* 1207 (1997).

lender from suffering from an unfair treatment as long as the amount of damages was easy to assess without error. But the need to estimate the reorganization value in different states of the world changes the picture, as it is not immediately evident that this will result in an accurate assessment. And precisely here is where I suggest that anchoring enters the picture and prevents strict liability to be a solution.

In the simple model presented in the example above, both reorganization values need to be assessed by an adjudicator who, to use Rawls figure, won't likely be behind a veil of ignorance. In a way, an anchor for  $R^+$  and  $R^-$  will be given as the party bringing up the suit against the controlling lender will come up with a number for what  $R^+$  and  $R^-$  and they will communicate this amounts to the court. As receiving a larger amount of damages than what the moving party asked for is unlikely, the reorganization estimates are likely to be biased towards being larger. Therefore, if either  $R^+$  or  $R^-$  is assessed in a bias way towards the amounts suggested by the moving party (or his expert witness), then a strict liability rule will not limit the effects of cognitive errors. The overestimation of  $R^+$  and  $R^-$  won't be due to hindsight, as it is not a probability assessment, but most likely due to anchoring, leading to a suboptimal assessment of the damage amount.<sup>448</sup>

As it was hinted above, the same analysis should be applied to adjudications of liability under the duty of care, regardless of using the BJR or other liability rule as the appropriate standard. The BJR requires an assessment of damages which also depends on a counterfactual (what value would the firm have, had the manager/ director acted differently) which inevitably leads towards an assessment of the damage amount by

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<sup>448</sup> Another possibility of bias may be due to representativeness heuristics (i.e. a great description of the firm). See Amos Tversky & Daniel Kahneman "Judgment Under Uncertainty: Heuristics and Biases", in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, Daniel Kahneman, Paul Slovic, & Amos Tversky eds., Cambridge University Press, New York, NY (1982), p. 8.

the adjudicator. As a result, a strict liability rule would not achieve an efficient outcome as previously advanced by Rachlinski due to the interplay in this case also of anchoring and hindsight bias. This analysis can be extended to any unilateral precaution situation where a counterfactual valuation and probability assessment need to be conducted. In these cases, a strict liability rule cannot be thought of as a debiasing technique.

To sum up, a controlling lender may accurately estimate probabilities *ex ante* and therefore avoid problems related to hindsight bias if a strict liability rule were to be used. Nonetheless, as other values need to be estimated (i.e. the value of the reorganized firm under some states of the world), these estimates are outside of his control (actually decided upon by the adjudicator) and based on a counterfactual type of analysis, a strict liability rule will likely be an inadequate debiasing legal tool for lender control liability. The efficiency of a lender control liability case then depends not just on hindsight bias but also on anchoring, the magnitude of the distortions and maybe the effects of these two heuristics on each other, if any.<sup>449</sup> As a corollary, the same analysis applies to adjudications of liability arising from alleged violations of the duty of care by managers/ directors, and hence a strict liability rule won't guarantee an adequate level of care by those managers/ directors.

### **B. A no liability rule for lender control liability?**

As it was mentioned above, even though Rachlinski believed that a strict liability rule would avoid the problems generated by hindsight bias in cases alleging breach of fiduciary duties by directors, some contextual elements implied that it was

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<sup>449</sup> In relation to their experiment Kamin and Rachlinski discuss hindsight bias interaction with anchoring. See Kim A. Kamin & Jeffrey J. Rachlinski "Ex Post  $\neq$  Ex Ante: Determining Liability in Hindsight", 19 Law & Hum. Behav. 89, 101 (1995)

better to have a no liability rule as the BJR. If a no liability rule for individuals in control was judged appropriate for directors when avoiding hindsight bias problems was considered possible through a strict liability rule, then it could be argued that a no liability rule would be even better fitted for lender control liability cases where cognitive errors seem to be unavoidable. Should we then advance a no liability rule policy, as I have alleged in the previous chapter that courts usually do, for lender control liability cases?

In order to answer this question, it will be helpful to look at the arguments that justified the no- liability rule for breach of fiduciary duties in general, as lender control liability could be understood as a special case of the later. There are two sets of different yet complementary arguments in favor of a no- liability rule: (i) one set is composed by what would happen otherwise type of arguments, which I refer to as “consequentialist fear” type of arguments; and, (ii) the other is based on what alternatives exist to prevent damages of large magnitude from arising under a no- liability rule, which I refer to as “functional alternatives”. On the first set of arguments, “consequentialist fear”, we find three strands all of which arise in one way or another from the inability of judges to evaluate correctly directors’ and officers’ conduct.<sup>450</sup> First, Rachlinsky claimed that the BJR works as a no liability rule in order to avoid excessive precautions and, more generally, risk aversion from managers who are heavily invested on the firm.<sup>451</sup> Second, Rachlinsky posited that a no-liability BJR prevents the best qualified manager prospects from not accepting a managing position

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<sup>450</sup> See Geoffrey P. Miller “A Modest Proposal for fixing Delaware’s Broken Duty of Care”, NYU Law and Economics Research Paper No. 09-41, available at [http://lsr.nellco.org/cgi/viewcontent.cgi?article=1200&context=nyu\\_lewp](http://lsr.nellco.org/cgi/viewcontent.cgi?article=1200&context=nyu_lewp) (last visited 06/11/10) (claiming that the justification for inaction is that Delaware courts lack the ability to monitor, an observation extending back at least as far as Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) - “judges are not business experts”-).

<sup>451</sup> See Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 U. Chi. L. Rev. 571, 619-23 (1998).

due to the fear of liability.<sup>452</sup> Finally, Bainbridge suggests that a rule which moves away from no-liability would undermine the social norms of group behavior which in turn constrain bad decision making.<sup>453</sup> The second group of arguments, “functional alternatives”, suggest that assigning a termination option to the shareholders to fire managers (in our case the option would be assigned to debtor’s lender), actually constrain rather effectively managers’ misbehavior. Additionally, and specifically for lender control liability, it is argued that creditors’ termination rights would not be abused due to the danger of damaging the creditor reputation as well as from the ability to obtain credit from other sources.<sup>454</sup> Thence, a creditor would use its termination rights as additional leverage to increase or complement its monitoring abilities.<sup>455</sup>

Let’s start by looking at the excessive precaution argument. Everyone seems to agree that risk aversion is something to avoid when looking for a business manager (or, a controlling party).<sup>456</sup> Business decision making requires constant risk taking which makes risk aversion a fast lane to sub- optimal performance. In spite of using an approach at odds with the BJR (imposing a liability regime instead of a no liability one), secured lender control liability also looks essentially to limit excessive

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<sup>452</sup> See Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 U. Chi. L. Rev. 571, 619-23 (1998).

<sup>453</sup> See Stephen M. Bainbridge “Why a Board? Group Decisionmaking in Corporate Governance”, 55 Vanderbilt Law Review 1, 49-50 (2002).

<sup>454</sup> Buckley, for example, discusses reputation costs in order to limit opportunistic termination of managers by lenders. See F.H. Buckley “The Termination Decision”, 61 UMKC. L. Rev. 243, 269 (1992) (“Under costly signaling theories, the issuance of unconstrained termination rights signals high firm quality. While such rights increase the costs of creditor misbehavior, such costs are more easily borne by highly solvent firms. Although the creditor is permitted to terminate at any time, he will realistically be constrained from terminating solvent firms by reputational sanctions for creditor misbehavior.”).

<sup>455</sup> See F.H. Buckley “The Termination Decision”, 61 UMKC. L. Rev. 243, 277-8 (1992).

<sup>456</sup> Rachlinski, for instance, considers that if excessive precautions are undertaken general economic activity would be undermined. See Jeffrey J. Rachlinski “A Positive Psychological Theory of Judging in Hindsight”, 65 U. Chi. L. Rev. 571, 622-3 (1998)

precautions, a point which appears to have been missed by previous researchers.

In order to see why, it is convenient to focus on the incentives which the different parties hold. As I mentioned in the previous chapters, a controlling lender obtains such a role in a business reorganization through having most if not all the assets of the debtor encumbered, being a post-petition lender (i.e. not being captured by the automatic stay provisions) and contracting for very stringent covenants on the part of the debtor which serve as extra sensitive trip wires. As these trip- wires could be triggered at any point, the lender becomes extremely necessary to provide the debtor with contractual waivers in order to avoid a default. Through the waiver mechanism the lender can impose its preference over risk- taking as well as the path towards his desired outcome. These preferences are well documented to lead toward insufficient risk- taking and a liquidation bias for the bankruptcy process,<sup>457</sup> especially when total amount of debt owed to the controlling secured lender is less than the value of the assets securing the debt.

The rest of the reorganization claimants have lower priority and therefore would probably prefer higher levels of risk taking which would raise the expected value of their claims, as well as raising the value of the real option of delaying the shutdown decision.<sup>458</sup> As a result, it is most likely that these lower priority claimants would bring a lender control liability claim against the higher priority controlling lender when not enough risk taking was exercised than otherwise. Then, permitting

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<sup>457</sup> The liquidation bias is broadly recognized. See for example Douglas G. Baird & Robert K. Rasmussen "Private Debt and the Missing Lever of Corporate Governance", 154 U. Pa. L. Rev. 1209, 1246 (2006).

<sup>458</sup> On risk taking and option value of keeping the firm running, see Douglas G. Baird & Edward Morrison "Bankruptcy Decision Making", 17 J. L. Econ. & Org. 356, 358-62 (2001) ("The ability to postpone the shutdown decision has value and should be factored into the calculation when deciding whether to shutdown the firm... The value of the option increases as the uncertainty about future earnings increase.")

lender control liability cases to come forward would limit excessive precautions and risk-aversion in general by the controlling lender.

The second consequentialist fear argument focuses on preventing that top qualified individuals reject managing positions,<sup>459</sup> doesn't have equal importance for lender control liability cases as the lender itself is the one being sued. Nonetheless, the present problem is closely related to the disincentive which lenders may have to lend, under the assumption that if lenders are going to be sued then they will either charge for their services more or decide not to lend. While this is possible, it may not be as large of a problem as it may seem at first sight. On the one hand, lenders who provide DIP loans are typically the main lenders from before the initiation of the bankruptcy proceeding. As a result, main lenders will still have an important incentive to lend once the debtor enters a reorganization proceeding in order to better continue monitoring the debtor.<sup>460</sup> On the other hand, if lenders are today relying on obtaining control of a bankrupt debtor in order to price their loans, then those loans could be artificially low. In other words, DIP loans may be too cheap if the lender knows that he will get extra rents out of acting opportunistically once in control. Hence, more expensive lending could actually imply a more efficient allocation of resources.

The last consequentialist fear argument was advanced by Bainbridge within his group decision-making theory of boards.<sup>461</sup> Bainbridge believes that the firm must be

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<sup>459</sup> See, for example, Bernard S. Black, Brian R. Cheffins & Michael Klausner "Outside Director Liability", 58 *Stan. L. Rev.* 1055, 1140 (2006) who in the context of analyzing outside director liability conclude that the limited deterrence is justified as "[a] significantly higher level of risk for outside directors could well deter good candidates from serving and make directors who do serve excessively cautious and process conscious, which could reduce rather than enhance company value"

<sup>460</sup> Otherwise, they risk putting the monitoring into another lender's hand whose interests may be conflicting with those of the original lender.

<sup>461</sup> See Stephen M. Bainbridge "Why a Board? Group Decisionmaking in Corporate Governance", 55 *Vanderbilt Law Review* 1 (2002).



viewed as a set of production teams embedded within a hierarchical structure. At the top of this hierarchy stands the board of directors, a collective body which is able to benefit from the advantages of group decision-making over individuals relative to critical evaluative judgment.<sup>462</sup> One of the advantages arising from having a collective body as the ultimate decision maker is that it provides checks for individual overconfidence and alternative viewpoints from equally situated individuals. In addition, it creates a “network of reputation and other social sanctions”.<sup>463</sup> Bainbridge believes that BJR as a no-liability rule can be understood as a way to prevent disruptions to social norms or personal relationships which are key to the development of social pressure.<sup>464</sup>

Whatever real bite this argument has in justifying a no liability rule as the BJR, it clearly cannot carry the same weight into LCL cases. Naturally, as a lender obtains control of a debtor and especially in those cases where the lender obtained control by informal means, whatever social norms applied to the board of directors as a decision making body become largely irrelevant for decision making purposes. The relevant social institutions now are whichever ones, if any, are in place within the creditor restructuring department. As a result, there shouldn't be any qualms about imposing LCL at least with respect to the disruption of board of directors' social norms.<sup>465</sup>

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<sup>462</sup> See Stephen M. Bainbridge “Why a Board? Group Decisionmaking in Corporate Governance”, 55 *Vanderbilt Law Review* 1, 27-30, 33-7 (2002) (concluding that group interaction has synergistic effects allowing groups to outperform even the best decision-makers within the groups).

<sup>463</sup> See Stephen M. Bainbridge “Why a Board? Group Decisionmaking in Corporate Governance”, 55 *Vanderbilt Law Review* 1, 37 (2002).

<sup>464</sup> See Stephen M. Bainbridge “Why a Board? Group Decisionmaking in Corporate Governance”, 55 *Vanderbilt Law Review* 1, 49 (2002).

<sup>465</sup> It could be argued that the disruptive effect wouldn't occur within the debtor's board of directors but within the lender's one. I believe that such an argument would be incorrect, as the liability does not follow directly to the lender directors. As a result, it is not immediately clear how the network of social relationships and sanctions would be affected.

The second set of defenses towards a no- liability regime for lender control liability problems, the functional alternatives defense, looks at other means to avoid losses arising out of lender control which would make lender control liability adjudications trivial. Two are prominently suggested: one based on lenders' reputation; the other on alternative sources of credit.<sup>466</sup> The reputation story tells us that lenders are repeated players and that extracting value opportunistically from a distressed debtor would tarnish their reputation. Then, they will look at how much future business they would lose by behaving opportunistically and thence will decide not to. This argument relies on the ability of future trading partners to know whether a lender behaved opportunistically or not in a relation with others (i.e. how easy it is to identify opportunistic behavior). But lender control of a reorganization proceedings looks a lot more like murky Amazon waters than crystal ocean ones. A situation of informal take of control of a firm with far from optimal recent financial results is not a fertile ground for quality and consistent information. In addition, the creditor relative size may completely limit the reputation effect, likely due to its market power. In fact, in a recent study looking at the effects of large bankruptcies on lead syndication arrangers Gopalan, Nanda and Yerramilli found that

“... that the increase in lead allocation following large bankruptcies is confined only to small lead arrangers (lead arrangers within the 95th percentile in terms of syndication volume); i.e., large lead arrangers are unaffected by large bankruptcies... These results highlight a key limitation of the reputation mechanism, and may go some way towards

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<sup>466</sup> See Daniel R. Fischel “The Economics of Lender Liability”, 99 Yale L. J. 131, 138 (1989) (“... the lender must be concerned about the effect of opportunistic behavior on its reputation. Most lenders are typically larger than borrowers and more likely to be repeat players. Reputation will be a more effective deterrent to lender misbehavior, therefore, than to debtor misbehavior. Finally, the market for substitute performance or, more specifically, the availability of other sources of credit, limits lenders' ability to extract concessions from debtors. The size of any concessions must be smaller than the costs to the debtor of negotiating with a new lender.”)

explaining the concentrated nature of the loan syndication market.”<sup>467</sup>

As a result, it is rather unlikely that the reputation mechanism can work to prevent controlling creditors from behaving in an opportunistic way in a reorganization setting.

The other argument in favor of a no liability rule looks at the limit that an alternative source of credit would establish on the controlling lender opportunistic behavior, under the assumption that the size of any concessions to the lender must be smaller than the costs of obtaining a new lender. The determination of the cost of obtaining a new lender or even the availability of one (due to the time constraints) is an entirely empirical matter. There are good reasons to believe that these costs could be substantial. First, it wouldn't be easy to find a new source of money not just for current expenses but one that is willing to replace the whole loan of a controlling lender.<sup>468</sup> It would be even worse if it was a controlling syndicate. The evidence obtained by Gopalan, Nanda and Yerramilli mentioned above strongly suggests that alternative sources of finance are not easy to find.<sup>469</sup> Second, any prospective lender would be very skeptical of the debtor's chronicle of the events which led him to need a new lender given his financial condition. In addition to the standard information asymmetry problem between borrower and lender, debtors would have the problem of convincing the new lenders that they need them because their actual lender will behave in an opportunistic fashion. But perhaps most importantly, even if the

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<sup>467</sup> See Radhakrishnan Gopalan, Vikran Nanda & Vijay Yerramilli “Does Poor Performance Damage the Reputation of Financial Intermediaries? Evidence from the Loan Syndication Market”, working paper available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1571474](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571474) (last checked 05/19/10), at 5.

<sup>468</sup> Otherwise, the pre-existing lender would fight extremely hard against post filing priming liens.

<sup>469</sup> The recent credit market crunch following the burst of the housing bubble suggests that the alternative source of credit argument is especially weak in some contexts. In the case of smaller business which rely more heavily on regional banks as their source of credit, both the reputation and alternative source of credit arguments seem notoriously inadequate.

borrower is able to convince a new lender to fill in the shoes of an older lender it is not clear how the debtor will be able to preclude or limit ex post opportunistic behavior arising from the replacement.

As a result of all the previous arguments, it is unlikely that a no- liability rule as the BJR would promote risk taking by the controlling lender, or better allocation of lending funds. At the same time, it is problematic to argue that the size of any damages to be triggered by lender's opportunistic behavior will be trivial because of the constraints the credit market imposes or that the reputation costs will make the lender self- limit his opportunistic behavior.

#### **IV. Conclusion**

In this chapter, I have focused on the interplay of cognitive shortcomings and lender control liability adjudications. In doing so, I have exposed that even though lender control may not be optimal, cognitive errors may produce systematic distortions that challenge the application of lender control liability theories. These cognitive errors have been previously been linked entirely to hindsight bias. This chapter has uncovered that the widespread worries related to hindsight bias in the lender control liability adjudications would not be supported if hindsight bias was the only cognitive error affecting adjudications. Nonetheless, hindsight bias is not the only heuristic at play and which must be taken into account when thinking about lender control liability application. Anchoring plays a substantive role in distorting adjudicative decision making. Indeed, if it wasn't for the combined effects of hindsight bias and anchoring, strict liability would be an efficient legal tool to use in order to limit a controlling lender's opportunistic behavior.

As a result, this chapter has showed that a strict liability rule would fail to achieve first best outcomes. Additionally, this chapter conveyed that the beneficial effects from having a no- liability rule for breach of fiduciary duties, à la BJR, do not clearly translate into the lender control liability realm. If anything, those arguments seem to imply that a no- liability rule wouldn't improve the risk aversion problems associated to lender control, because of the liquidation bias that creditors in control have within the bankruptcy context. Finally, other opportunistic behavior constraints that are considered important in constraining managers within a no liability interpretation of the BJR appear to be empirically irrelevant in reorganization cases. Armed with these perhaps troubling insights, in the next chapter I will bring forward a proposal to amend lender control liability through modifying part of the Law of Agency applicable.

## **A new test for control in reorganizations**

### **I. Introduction**

The discussion in the earlier chapters should have made it clear by now that lender control of a reorganization process does not come without difficulties. While many bankruptcy legislations focus on the prevention of social problems associated to reorganization control in general,<sup>470</sup> the analysis put forward on the previous chapters has been concentrated on economic costs. Those economic costs can mainly arise out of the seemingly unfettered ability of a controlling creditor to make the exit decision of a corporate debtor in chapter 11. The concerns about those very costs has made a legal system previously structured around secured creditor control, as the English was before the Enterprise Act 2002, to switch into a system friendlier to other constituents.<sup>471</sup>

While a move towards allocating control outside the hands of the main secured creditor maybe a credible option, in this chapter I will argue that such an attempt is rather naïve and would encounter important practical difficulties. Specifically, as evidenced by the recent UK experience, attempts to wrestle control away from creditors have been largely ineffective as a practical matter. At the same time, it would fail to account for important advances in financial contracting, spawning from

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<sup>470</sup> See, for example, Rizwaan J. Mokal “Administrative Receivership and Administration – An Analysis”, 57 *Current Legal Problems* 355, 383 (2004) (stating that administrative receivership was changed because it was destructive to social value “in terms of unnecessary job losses and other resource misallocations”).

<sup>471</sup> See “A Review of Company Rescue and Business Reconstruction Mechanisms”, The Insolvency Service, London, UK, HMSO 1999.

Aghion and Bolton's seminal article.<sup>472</sup> Therefore, I will argue that a better way forward would be to address possible creditor control misbehavior through the use of a legal tool which has fallen out of use nowadays in the United States: lender control liability.<sup>473</sup> In this line, I will suggest that a sensible technique to address the problem would be to eliminate the negative control safe harbor of Agency Law for lender control liability cases within the context of reorganization cases. Further, I will argue that this approach will not generate out of proportion adjudications against lenders. In addition, even if the advanced proposal is empirically found to be ineffective, I believe that it would be an adequately conservative first attempt to limit a controlling lender opportunistic misbehavior.

This chapter will proceed as follows. Section II describes the experience in United Kingdom before the enactment of the 2002 Enterprise Act, which lead to coordinated efforts to restrict the main lender control of the administrative receivership. Section III looks again into the lender control liability problem and provides a proposal to optimize the current state of affairs by dropping the negative control safe harbor of Agency Law for lender control liability cases within the context of reorganization cases. Section IV provides a specific conclusion to this chapter and general remarks on possible ways to continue this line of research.

## **II. Creditor control problems and the experience of the United Kingdom**

The difficulties associated to creditor control of the reorganization process are not novel. They have been analyzed by scholars across the globe and at length in the

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<sup>472</sup> See Phillippe Aghion & Patrick Bolton "An Incomplete Contracts Approach to Financial Contracting", 59 Review of Economic Studies 473 (1992).

<sup>473</sup> On lender control liability's lack of bite, see Chapter III.

United Kingdom by both legal and finance academics. In the UK, a specific category of creditors<sup>474</sup> was afforded a great deal of power in the recent past. Up until the enactment of the 2002 Enterprise Act, a creditor holding a “floating charge”<sup>475</sup> had considerable leeway to decide what the future of the business would be through the appointment of an “administrative receiver”. This practice was facilitated by historical circumstances: because English law did not carry an automatic stay of creditors until 1985, private resolution of financial crises developed into the rule providing the necessary organization to this collective action problem.<sup>476</sup> Within that context, it is quite likely that the development of private resolutions of insolvency cases was advantageous as it helped to avoid a race to the assets by creditors which may have led to sub-optimal dismemberments of the debtor business.<sup>477</sup>

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<sup>474</sup> On this issue, see The Insolvency Service, *A Review of Company Rescue and Business Reconstruction Mechanisms* (London: TSO, 1999) ; John Armour & Rizwaan J. Mokal “Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002”, *Lloyds Maritime and Commercial Law Quarterly* 28 (2005); Rizwaan J. Mokal “Administrative Receivership and Administration – An Analysis”, 57 *Current Legal Problems* 355, 383 (2004); Sandra Frisby “In Search of a Rescue Regime: The Enterprise Act 2002”, 67 *The Modern Law Review* 247 (2004); John Armour, Brian R. Cheffins & David A. Skeel, Jr. “Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom”, 55 *Vand. L. Rev.* 1699 (2002); John Armour, Audrey Hsu & Adrian Walters “The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK”, working paper, available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=912302](http://papers.ssm.com/sol3/papers.cfm?abstract_id=912302) (last visited 05/14/07); Julian Franks & Oren Sussman “Financial Distress and Bank Restructuring of Small to Medium Size UK Companies”, 9 *Review of Finance* 65 (2005); Sergei A. Davydenko & Julian R. Franks “Do Bankruptcy Codes Matter? A study of Defaults in France, Germany and the UK”, 63 *Journal of Finance* 565 (2008); Julian Franks & Oren Sussman “Financial Innovations and Corporate Bankruptcy”, 14 *Journal of Financial Intermediation* 283 (2005); Julian Franks, K Nyborg and W Torous “A Comparison of US, UK, and German Insolvency Codes”, 25 *Financial Management* 86 (1996).

<sup>475</sup> In *National Westminster bank plc v Spectrum Plus Ltd* [2005] UKHL 41, the [House of Lords](#) described the essential characteristic of a floating charge as: “the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event. In the meantime the chargor is left free to use the charged asset and to remove it from the security.”

<sup>476</sup> See John Armour, Audrey Hsu & Adrian Walters “The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK”, working paper, available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=912302](http://papers.ssm.com/sol3/papers.cfm?abstract_id=912302) (last visited 05/14/07), at 2. Also see Rizwaan J. Mokal “Administrative Receivership and Administration – An Analysis”, 57 *Current Legal Problems* 355, 358 (2004).

<sup>477</sup> With no automatic stay in place, private resolution associated to a main security-holder would likely prevent the common pool problem taking place through a race to the debtor assets. See Thomas H. Jackson “Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain”, 91 *Yale Law Journal* 857 (1982); Stanley D. Longhofer & Stephen R. Peters “Protection for Whom? Creditor Conflict and Bankruptcy”, 6 *American Law & Economics Review* 249, 250 (2004) (“The unique aspect of bankruptcy law that supersedes the minutia ultimately determining a resolution is the mandate that



Perhaps as a result of the newly mandated creditor stay provision, the administrative receivership system was viewed as increasingly problematic by the end of the 1990's.<sup>478</sup> Essential to this critical assessment were two intensely connected issues: the artificially heightened incentives of a controlling lender to sell assets and an improper accountability. Regarding the first issue, and at the heart of the criticism, was the deep rooted belief that socially inefficient bankruptcy fire sales were more likely in those cases where an over-secured creditor was calling the shots, as the over-secured creditor wasn't the firm's residual claimant.<sup>479</sup> For example, Armour and Mokal described receivership as "giving an unhealthy amount of power to creditors holding floating charges, who because of their secured status lacked sufficient incentives to rescue failing companies"<sup>480</sup> The magnitude of the problem can be grasped as it was believed that secured creditors were under-secured in less than half of the insolvencies of the 1990's.<sup>481</sup> As a corollary, it was believed that receivership generated a bias against continuations and, in general, against a rescue culture.<sup>482</sup>

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requires a *coordinated* resolution involving *all* creditors. This prevents individual debt collection remedies that tend to destroy asset value"). On the common pool problem, see Garrett Hardin "The Tragedy of the Commons", 162 Science 1243 (1968).

<sup>478</sup> See Sandra Frisby "In Search of a Rescue Regime: The Enterprise Act 2002", 67 The Modern Law Review 247, 251 (2004), citing Productivity and Enterprise: Insolvency - A Second Chance Cm 5234 (London: HMSO, 2001), para. 2.2

<sup>479</sup> See John Armour, Audrey Hsu & Adrian Walters "The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK", working paper, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=912302](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=912302) (last visited 05/14/07), at 3.

<sup>480</sup> See John Armour & Rizwaan J. Mokal "Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002", Lloyds Maritime and Commercial Law Quarterly 28, 29 (2005).

<sup>481</sup> See John Armour & Rizwaan J. Mokal "Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002", Lloyds Maritime and Commercial Law Quarterly 28 (2005).

<sup>482</sup> See Sandra Frisby "In Search of a Rescue Regime: The Enterprise Act 2002", 67 The Modern Law Review 247, 252 (2004). The rescue culture was thought to be beneficial in those cases where the debtor firm was financially distressed, relative to those cases where the debtor firm was economically distressed. See Rizwaan J. Mokal "Administrative Receivership and Administration – An Analysis", 57 Current Legal Problems 355, 359 (2004). See also John Armour & Rizwaan J. Mokal "Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002", Lloyds Maritime and Commercial Law Quarterly 28 (2005) footnote 8 ("See, e.g., Hansard, *HL Deb* 2 July 2002, Col 188 (Lord MacIntosh of Haringey): 'We want to put company rescue at the heart of insolvency procedures because we want to save companies which have a decent chance of survival so that they are not driven to the wall

The second source of criticism stemmed from the definition of who were the beneficiaries of the receiver's fiduciary duties, namely the creditor holding a floating charge.<sup>483</sup> This rule created incentives for the receiver to disregard other constituencies' interests once appointed. Along these lines, it was argued that the procedure rendered the administrative receiver insufficiently accountable to those who were affected by her actions (i.e. other unsecured creditors).<sup>484</sup> For example, Armour and Mokal explained that

"The receiver, who was not an officer of the court, owed unsecured creditors few duties and their information rights amounted to little more than an entitlement to be told about what in most cases was a *fait accompli*."<sup>485</sup>

Additionally, those incentives created by the legal rule were further exacerbated by the fact that a floating charge holder had an unfettered ability to appoint the receiver, limiting any initial loyalty to other groups. Such a floating charge laden structure led Frisby to state that the "administrative receivership is heavily biased in favor of a single secured creditor, and it is but a small step from there to posit that the regime is detrimental to successful rescue initiatives."<sup>486</sup>

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unnecessarily.""); K.M.J. Kaiser "European Bankruptcy Laws: Implications for Corporations Facing Financial Distress," *Financial Management* 85 (Autumn, 1996).

<sup>483</sup> See Julian Franks, K Nyborg and W Torous "A Comparison of US, UK, and German Insolvency Codes", 25 *Financial Management* 86, 86 (1996) ("... in the UK, receivership gives control rights to a particular secured creditor, who has no duty to take account of the interests of other more junior creditors").

<sup>484</sup> See Insolvency Service (2001), *Insolvency—A Second Chance*, Cm 5234 (London: DTI).

<sup>485</sup> See John Armour & Rizwaan J. Mokal "Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002", *Lloyds Maritime and Commercial Law Quarterly* 28 (2005) (italics in original).

<sup>486</sup> See Sandra Frisby "In Search of a Rescue Regime: The Enterprise Act 2002", 67 *The Modern Law Review* 247, 252 (2004)

A particular manifestation of the unaccountability problem concerned administrative costs: it was commonly argued that over-secured lenders would fail to monitor the costs incurred by insolvency professionals in carrying out their functions.<sup>487</sup> As a result, the insolvency fees and remuneration expenditures would be needlessly and wastefully inflated further hurting unsecured creditors or even shareholders of the insolvent debtor. Again, the worry of oversecured creditors running the show supported the view demanding modifications to the Insolvency Act.

With these criticisms in mind, the new Act was designed to “facilitate company rescue and to produce better returns for creditors as a whole.”<sup>488</sup> Three core developments in the new legislation aimed at correcting the perceived deficiencies. First, administrative receivership was for most purposes abolished<sup>489</sup>, as Section 250 of Enterprise Act 2002 prohibits the holder of a qualified floating charge from appointing an administrative receiver. Second, the primary insolvency procedure became the new administration regime, designed to “capture the benefits of speed and flexibility associated with the receivership mechanism yet at the same time to foster accountability.”<sup>490</sup> The new regime flexibility is demonstrated by its allowance of out-of-court appointments, both by the holders of qualified floating charges and directors of the company.<sup>491</sup> The third major development has been to erase the Crown’s preferential status, in favor of having a portion of the floating charge reserved for

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<sup>487</sup> See Rizwaan J. Mokal “Administrative Receivership and Administration – An Analysis”, 57 *Current Legal Problems* 355, 359 (2004).

<sup>488</sup> See John Armour & Rizwaan J. Mokal “Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002”, *Lloyds Maritime and Commercial Law Quarterly* 28, 28 (2005)

<sup>489</sup> See John Armour & Rizwaan J. Mokal “Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002”, *Lloyds Maritime and Commercial Law Quarterly* 28, 35 (2005)

<sup>490</sup> See John Armour & Rizwaan J. Mokal “Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002”, *Lloyds Maritime and Commercial Law Quarterly* 28, 29 (2005).

<sup>491</sup> See Sandra Frisby “In Search of a Rescue Regime: The Enterprise Act 2002”, 67 *The Modern Law Review* 247, 258-9 (2004) (“Either the company or its directors can appoint an administrator under paragraph 22 unless a petition for winding up has been presented, an administration application made or an administrative receiver is in office.”)

distribution among the general unsecured creditors.<sup>492</sup>

Equally important to these structural changes are the new objectives that the administrator has to follow. An administrator has a duty to act in furtherance of precise objectives:

- “(a) rescuing the company as a going concern, or
- (b) achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first being in administration), or
- (c) realising property in order to make a distribution to one or more secured or preferential creditors.”<sup>493</sup>

These objectives are set in a hierarchical way. Therefore, the administrator can only pursue objective (c) if the others are not *reasonably practicable* and following (c) doesn’t unnecessarily harm creditors.<sup>494</sup> In addition, the administrator must follow (a) unless he believes that it is not reasonably practicable to achieve that objective or if objective (b) would bring about a better result for creditors as a whole.<sup>495</sup> Finally, and clearly aiming for a greater accountability, the Enterprise Act mandated administrators to perform their functions in the interests of the company’s creditors as a whole.<sup>496</sup>

The changes to the Insolvency Act of 1986 worked primarily to limit the controlling creditor discretion as a way to prevent possible abuses. Nonetheless, it didn’t go as far as to eliminate the controlling lender influence, something I believe should be applauded. Indeed, it would arguably have been naive to discard the main

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<sup>492</sup> This final change also signals a political move towards not leaving the weakest claimholders without redress.

<sup>493</sup> Insolvency Act 1986, Sch. B1, para. 3(1)

<sup>494</sup> Insolvency Act 1986, Sch. B1, para. 3(4)

<sup>495</sup> Insolvency Act 1986, Sch. B1, para. 3(3)

<sup>496</sup> Insolvency Act 1986, Sch. B1, para. 3(2)

lender as a relevant decision making actor in a reorganization process, especially given creditors' relational knowledge of many distressed borrowers and large economic interest in all of them. Additionally, eliminating or largely limiting the controlling lender influence maybe impractical as economic interests always seem to find a way to manifest themselves.<sup>497</sup> In this regard the new United Kingdom legislation still provides a prominent role for qualified holders of floating charges, as between different types of administrators' appointments, appointments done *by* a qualified floating charge holder, either out of court or once an insolvency proceeding has been opened, enjoys priority,<sup>498</sup> regardless of the risk that administrators get captured by appointing banks.<sup>499</sup>

### **III. Lender Control Liability as a source of creditor accountability**

The experience from the United Kingdom expresses concern about a view of lender control of the reorganization process as coming without costs. Unfortunately, those costs are usually not the easiest to observe. Indeed, the process of receivership was usually regarded as speedy and with great adherence to the debt contract,

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<sup>497</sup> Two clear examples of the ways lenders find to manifest their influence are the appearance of a bankruptcy claim market at the beginning of the 90's and the development of the market for distressed firms in the late 90's and early 2000's. Additionally, public choice theory strongly suggests that eliminating powerful lenders' influence would be impractical.

<sup>498</sup> See John Armour & Rizwaan J. Mokal "Reforming the Governance of Corporate Rescue: The Enterprise Act of 2002", *Lloyds Maritime and Commercial Law Quarterly* 28, 37 (2005) ("If the company or its directors wish to appoint an administrator out-of-court, they must first give five days' notice to any QFCH, who may then appoint an administrator themselves under paragraph 14 in the interim. If an administrator has been appointed under paragraph 14, then the directors may not appoint under paragraph 22. Similarly, if an administration application has been made to the court under paragraph 11, any QFCH must be notified of the application, and will then have the right to petition the court to have a specific person appointed as administrator", citing Insolvency Act 1986, Sch B1, para 12, 25-6).

<sup>499</sup> See John Armour, Audrey Hsu & Adrian Walters "The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK", working paper, available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=912302](http://papers.ssm.com/sol3/papers.cfm?abstract_id=912302) (p. 5) ("Banks typically operate 'panels' for the selection of accountants to act as their insolvency practitioners, which will impose reputational constraints on the latter's actions: those appointees who take steps contrary to the banks' interests in the course of an appointment may expect not to be appointed again.")

signaling that direct bankruptcy costs were generally not a great cause of concern.<sup>500</sup> As time goes on, gradual identification of those less visible costs comes about, which goes in line with the analysis presented in previous chapters. The question then is how to limit those costs, while at the same time not unduly compromising the important involvement of the secured controlling creditor in the proceedings.

As it was discussed at length in chapter III, today lender control liability cases are especially difficult to win because an understanding of the theory of the firm as an explicit nexus of contracts prevents any visualization of injustice in the fact that a lender obtains control. Understood in this way, the use of the Law of Agency's safe harbor to prevent gains of control seems largely innocuous. It follows that as the paradigmatic view of the firm as an explicit nexus of contracts is dropped the use of Law of Agency's analytical framework should be reexamined.

Let's recap a little to clarify what will follow. As it was mentioned above, judicial control determinations are heavily dependent on formalities. Two of them are especially important. First, if borrower and lender elicit that they are acting on their own best interest, then when the control determination question is faced by an adjudicator such borrower and lender manifestations are something that needs to be overcome by the party claiming lender control. Second, in order to determine whether the lender was in control of the borrower when parties manifest to be acting on their own behalf, the Law of Agency has a safe harbor which establishes that negative control, such as bargained for veto power,<sup>501</sup> cannot amount to convert a lender in a

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<sup>500</sup> See Julian Franks, K Nyborg and W Torous "A Comparison of US, UK, and German Insolvency Codes", 25 Financial Management 86, 100 (1996)

<sup>501</sup> Veto power are at the most basic level a take it or leave it game, though "this simple procedure is [often] embedded in more complex procedures". See Charles Cameron & Nolan McCarty "Models of Vetoes and Veto Bargaining", 7 Annual Review of Political Science 409, 410 (2004).

controlling lender. If we assume that a controlling lender will not willingly manifest that he is actually running the debtor's show in order to avoid liability, then a re-examination of the Law of Agency safe harbor appears to be the best way forward.

Traditionally, negative control or veto powers were considered a way to maintain a given status quo.<sup>502</sup> Under this interpretation, the veto power has only been geared to avoid changes while proposing powers rested with directors and management.<sup>503</sup> Hence, agenda control was supposed to be much more responsive to the later than to the former, leaving the veto powers merely as an anchor on the status quo.<sup>504</sup> As a result, exceptionally used veto powers were associated to mere decision control rather than decision management, using the wording of Fama and Jensen.<sup>505</sup>

Once negotiations become frequent in the reorganization context the nature of veto powers morphed greatly, enough to be able to determine actions. Such is the case of a controlling lender who is able to negotiate for enough positive and negative covenants as to make sure that contractual technicalities' effectively serve as an adjustable corset on debtor decision-making.<sup>506</sup> What was thought at the time when

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<sup>502</sup> For instance, in a political science context, McCarty and Poole consider that the veto power is described as providing "an additional safeguard against "unwise" measures that might be passed." See Nolan M. McCarty & Keith T. Poole "Veto Power and Legislation: An Empirical Analysis of Executive and Legislature Bargaining from 1961 to 1986", 11 *Journal of Law, Economics, & Organization* 282,4 (1995).

<sup>503</sup> Again, McCarty and Poole in the constitutional context mention that "the extent of the president's influence is that the veto will prevent the passage of proposals that the president considers inferior to the previous status quo or reversion policy." See Nolan M. McCarty & Keith T. Poole "Veto Power and Legislation: An Empirical Analysis of Executive and Legislature Bargaining from 1961 to 1986", 11 *Journal of Law, Economics, & Organization* 282, 4 (1995).

<sup>504</sup> For a description of agenda control theory see Thomas Romer & Howard Rosenthal "Political Resource Allocation, Controlled Agendas, and the Status Quo", 33 *Public Choice* 27 (1978).

<sup>505</sup> See Eugene F. Fama & Michel C. Jensen "Separation of Ownership and Control", 26 *Journal of Law and Economics* 301 (1983). The authors believe that an organization decision process consist on decision management, involving initiation and implementation, and decision control, which involves ratification and monitoring.

<sup>506</sup> The corset image serves to identify that the controlling lender would only loosen the lace enough to allow for breathing room for the debtor once he chooses an action which the controlling lender believes appropriate.

contractual limitations backed by secured credit didn't carry as much force, is largely inadequate nowadays as a proxy to establish whether control is obtained or not. The negative control category seems to have little to do with reality, as both legal and finance scholars regularly point to actual transfers of control achieved only through negative control.<sup>507</sup> Indeed, it may merely be a matter of semantic quibbles, as the use of negative dynamic definitions may turn to be equivalent to instructions as a control mechanism. If this is supported by informal recommendations or communications that further guide the debtor actions towards the lender's preferred path, then it is almost impossible not to think as the lender having control.<sup>508</sup>

### **The Problem with formalities as a no liability rule**

As I have discussed above, an actor's level of care needs to be linked to the possible level of harm produced by his underlying activity in order to allow for the internalization of the costs he generates. A clear example of the former comes from the classic law and economics models of optimal levels of harm with unilateral precautions presented by Shavell and explored in Chapter IV.<sup>509</sup> Tying the level of care to the level of harm caused by the underlying activity generates a positive correlation between the harm produced by the potential injurer and the liability he will incur.<sup>510</sup>

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<sup>507</sup> Agency law has had this distinction even before the appearance of the explicit nexus of contracts theory of the firm, as can be seen on section 14(o) of the Restatement (Second) of Agency Law (1958). Nonetheless, it could be argued that the emergence of this theory has served to support this categorization. It could be argued, though, that the negative control category is, as proposed in other contexts, an "attempt to avoid relying on hindsight by identifying an ex ante norm to apply." See Jeffrey J. Rachlinski "Heuristics and Biases in the Courts: Ignorance or Adaptation?", 79 Or. L. Rev. 61, 72 (2000)

<sup>508</sup> This is exactly what the financial and legal literature has recognized. See generally chapter II.

<sup>509</sup> See Chapter IV above.

<sup>510</sup> Additionally, as discussed in Chapter II, lender control liability can help to limit a form of rent extraction, i.e. reducing the value of the assets in freeze out sort of sale.



When formalities intervene to generate a no liability rule, as we explained in Chapter III for negative control and lender control liability,<sup>511</sup> level of care considerations shift from a focus on the underlying activity (both its level of harm and the probability of harm occurrence) to a focus on conforming with the formalities required by the law as safe harbors against liability (i.e. the ones that assure that no control will be found by a DIP lender and therefore no liability will be attached to his actions). And if the system eradicates the probability that the DIP lender will be found to be in control, then a rational profit maximizing DIP lender will always prefer to leave other constituents unprotected from his potentially harmful actions if precaution costs are higher than the costs of complying with the safe harbor requirements.

The end result of this legal alchemy is to produce a clear break in the incentives of a DIP lender in control: he will have an incentive to engage in an efficient level of precaution only up to the point where the costs of precautions equal the cost of complying with safe harbor provisions; once the former costs exceed the latter he will dismiss any considerations towards the potential harm he may inflict in other claimants. The perils of this legal strategy are evident and have been recognized for long, even by one of the authors of TEB. In the words of Baird and Jackson

“Complete deference to creditor protection in fashioning legal rules makes no more sense than complete deference to debtor freedom. Any device that protects creditors inevitably brings costs as well as benefits.”<sup>512</sup>

I believe that a possible way to attack this problem is quite simple, perhaps

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<sup>511</sup> See Chapter III above.

<sup>512</sup> See Douglas G. Baird & Thomas H. Jackson “Fraudulent Conveyance and its Proper Domain”, 38 Vand. L. Rev. 829, 836 (1985)

rather obvious.<sup>513</sup> As a matter of fact, I advance that the easiest way to put back in synch the controlling lender's precaution incentives with his ability to cause harm while at the same time not naively looking to eliminate a principal lender's influence is to drop the negative control safe harbor from agency law when dealing with lender control liability cases within bankruptcy proceedings. This would ensure the availability of a means for the bankruptcy estate to recoup any possible losses resulting from suboptimal controlling lender behavior. Naturally, any proposal of this sort will need to overcome several criticisms. I believe that the arguments against such a proposal are of two kinds. First, there would be worries that dropping the safe harbor would be overbroad, opening the gates for opportunistic and inefficient lawsuits.<sup>514</sup> Second, there would be worries that dropping the safe harbor would not achieve enough. I analyze those objections seriatim.

The first kind of objection considers the possibility that even if it was true that dropping the safe harbor from agency law when dealing with lender control liability cases within bankruptcy proceedings would help to avoid inefficient exit options, it may at the same time open the gate for other inefficient lawsuits. In fact, banking law practitioners often warn observers about the legal perils of distressed lending.<sup>515</sup> Indeed, given the deep pockets that controlling lenders usually have, it is natural for them to be lawsuit targets in bankruptcy cases, therefore helping to increase the debtor moral hazard problem. I believe that this type of criticism can easily get overblown. First, even if the agency law safe harbor is dropped, it will not be easy to demonstrate that the lender was in control rather than merely exercising influence, especially as

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<sup>513</sup> It's important to remember that, as I explained in Chapter IV, a no-liability rule is not an adequate option to solve the lender opportunistic behavior problem in the reorganization context.

<sup>514</sup> And, therefore, dropping the safe harbor would generate inefficient incentives *ex ante* also.

<sup>515</sup> As an early example of this, see generally James P. Koch "Bankruptcy Planning for the Secured Lender", 99 *Banking L. J.* 788 (1982).

borrowers do not have a duty to keep records of their conversations with their lenders.<sup>516</sup> Indeed, such a change to the law would presumably not affect the general way judges have of analyzing these types of disputes and specifically how scrupulous courts are towards making the subtle distinction between influence and control.<sup>517</sup> Second, even if the lender was found in control, it would still not be easy to prove that any harm was made by any lender's decision. This is point that has often been missed as Lawrence explains that

“Rather than recognizing that control is a necessary element for finding liability under a variety of different theories, the tendency has been to treat lender control itself as a basis for liability... The false assumption is that control alone leads to liability.”<sup>518</sup>

But even in those cases where courts find that a lender was in control and that he caused harm to the bankruptcy estate, it is likely that out of proportion damages would be reversed.<sup>519</sup> All three counterarguments suggest that even if the moral hazard problem of was enlarged by lender control liability, other checks would limit its size.<sup>520</sup> As a result, I do not believe that this line of argument is strong enough as to

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<sup>516</sup> Hence, knowledge about the degree of lender capture that exists maybe very difficult to find.

<sup>517</sup> See *Thomas Pearson v. Component Technology Corporation; General Electric Capital Corporation*, 247 F.3d 471, 506 (3<sup>rd</sup> Circuit, 2001). It must be noted that there is a clear understanding of the positive effects of monitoring by lenders, even by advocates of lender liability. See for example Jeremy W. Dickens “Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of “Control””, 65 Tex. L. Rev. 801, 824, 837 (1987) (“*Financial advice* offered to a debtor should *not establish a fiduciary duty* if the advice does not exceed the “careful watch” a prudent creditor would maintain. Indeed, a creditor may exercise a significant degree of *daily monitoring* of its debtor *without thereby becoming a fiduciary*... the ability to influence policy decisions of a financially troubled debtor is not the type of control that will trigger the insider standard of review for equitable subordination.” “[It is not sufficient in order to impose liability that] the debtor voluntarily permitted the creditor to take an active role in the management of the corporation.”)

<sup>518</sup> See William H. Lawrence “Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing”, 62 S. Cal. L. Rev. 1387, 1388 (1989).

<sup>519</sup> See 42 Am. Jur. Trials 419 § 2 (““In the wake of *Farah* and *K.M.C.*, a huge wave of lender liability cases followed, many of which resulted in large verdicts in favor of borrowers. During one four-week period in California alone, three multimillion dollar jury verdicts were awarded against three California banks. However, just as suddenly as these borrower victories appeared, many were reversed by appellate courts.”)

<sup>520</sup> At the same time, it should be noted that, as my focus has been on lender opportunistic behavior, I have not discussed the positive effects that lender liability has on the over-leveraging problem. On this

completely foreclose the possibility of redress, i.e. the current state of affairs.

The second type of criticism to my proposal would attack it from the opposite angle claiming that it underachieves, perhaps grossly. Actually, if the ability to prove that a lender is in control and that any harm was done is as difficult as I mentioned in the previous paragraph, it could certainly be argued that the proposal fails to achieve its main purpose. This is the sort of criticism I feel more comfortable dealing with, because the present work was never intended to be an attack on the idea of bankruptcy financing or lender monitoring, both of them extremely necessary to provide for prompt business recovery. Indeed, note that under this line of criticism the worst that can happen is that a controlling lender's incentives are unchanged even after dropping the safe harbor. Problematic as it may be, opting for merely dropping the safe harbor can be thought as the first step towards limiting gross controlling lender misbehavior and only after it is shown that it has no effect on lender behavior other more taxing options could be explored.<sup>521</sup> As a result, I believe that dropping the safe harbor, at least for lender control liability within reorganization cases, could provide better prospects to limit opportunistic behavior by lenders in control.

#### **IV. Conclusion**

In this chapter, I have provided further evidence that lender control indeed comes along with important costs. The experience of the United Kingdom suggests that unchecked lender control is problematic. At the same time, the changes to the Insolvency Act generated by the 2002 Enterprise Act also point out to the fact that eliminating lender influence altogether would most likely be prejudicial, given the

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issue, see generally, Yeon-Koo Che & Kathryn E. Spier "Strategic Judgment Proofing", working paper, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1159184](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1159184) (last visited 08/13/08).

<sup>521</sup> Note that as LCL may generate under monitoring if lending firms are scared of being considered in control, therefore increasing agency costs, looking for the least taxing option must be a priority.

lender's important role in monitoring and curbing the debtor's own misbehavior.<sup>522</sup> Indeed, even after the changes introduced by the 2002 Enterprise Act Armour, Hsu and Walters believe that in the United Kingdom it is "practically impossible in many cases for an administrator, even if so minded, to achieve an outcome contrary to that desired by the secured creditor."<sup>523</sup>

I have argued that lender control liability as currently understood provides no check for lender misbehavior as it has little if any practical bite in limiting lender opportunistic self-serving behavior. The proposal advanced in this chapter in order to deal with lender control problems is admittedly modest. I believe, nonetheless, that it follows the same line of reasoning that the drafters of the Restatement on the Law of Agency used. These drafters were not financial industry lobbyists trying to get the biggest possible share of the pie for their clients. They most likely had a legitimate worry on sight which arguably was the same one that debtors have when they decide to contractually bond themselves with stringent contract clauses. When debtors bond themselves they know that they are losing some decision-making leeway, but nonetheless they do it to signal their quality as debtors and ultimately to obtain better deals for themselves.

The Restatement drafters had these types of considerations in mind. The drafters knew that lenders bargain hard for contractual rights in order to cover against the debtor's possible financial troubles. Therefore, in order not to hamper economic activity, lenders would be benefited by the assurance that their attempts to recover

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<sup>522</sup> It is very unlikely that bankruptcy trustees, examiners or the like would be able to provide enough checks on debtor misbehavior as to make the lead lender role redundant.

<sup>523</sup> See John Armour, Audrey Hsu & Adrian Walters "The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK", working paper, available at [http://papers.ssm.com/sol3/papers.cfm?abstract\\_id=912302](http://papers.ssm.com/sol3/papers.cfm?abstract_id=912302) (p. 5)

from the debtor in a non wasteful manner would be protected from ill-founded liability attacks. The way the drafters found to give a clear assurance to lenders came in the form of the negative control category, where bargaining for veto power for certain decisions doesn't amount to obtaining actual control. What the drafters probably didn't have in mind though is that much more than mere veto power could be achieved through extensive use of negative covenants and continuous and informal lender-borrower communications. Connecting this fact with the more comprehensive theories of the firm than the explicit nexus of contracts, as discussed in Chapter I, clearly shows that the drafters' *creature*, i.e. negative control safe harbor, has a few problems.

At the same time, the proposal advanced in this chapter tries to capture some of the insights from the analysis provided in Chapter IV. In that chapter it was concluded that systematic cognitive errors may affect damages determinations in lender control liability cases due to the interaction of both hindsight bias and anchoring. Additionally, in Chapter IV it was noted that a no-liability rule cannot work in lender control liability cases in the same way as it does for director liability cases under the business judgment rule. I believe that dropping the negative control safe harbor as proposed above supports the finding that a no-liability rule for lender control cases does not share the advantages of a no-liability rule under the business judgment rule. Furthermore, only dropping the negative control safe harbor gives the system flexibility (removing the artificial restriction affecting controlling lenders) while at the same time it doesn't make proving control much easier, especially given how scrupulous courts have promised to be in differentiating influence from control.

There are several avenues for future research stemming from the work done in this thesis, three of which I outline here. First, as the theory of the firm shows that

there may be value not captured by legal claims, it would be interesting to investigate whether bankruptcy definition of claims should be enlarged to incorporate some of these economic factors today not accounted for by bankruptcy laws. Such a study would work towards better defining efficiency allocations and distributional justice. Second, the relation between different heuristics used in control liability adjudications seems to be a fruitful field for future research. Questions regarding the potential influence of anchoring on hindsight bias or hindsight bias on anchoring or both need to be answered to provide better policy recommendations. In addition, an assessment of the overall effect of heuristics, given the individual variation on cognitive errors, would be especially helpful.<sup>524</sup> Finally, it would be interesting to explore the accuracy of the common assumption in the literature stating that control shifts to the lender after covenant violations.<sup>525</sup> Such a study would help in assessing the magnitude of the societal costs generated by refusing to accept the possibility of lender control costs, as well as better being able to differentiate between mere influence and control.

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<sup>524</sup> For discussions on individual variation, see Jeffrey J. Rachlinski “Cognitive errors, Individual Differences and Paternalism”, 73 U.Ch. L. Rev. 207 (2006); and, Christine Jolls & Cass R. Sunstein “Debiasing through Law”, 35 J. Legal Stud. 199 (2006)

<sup>525</sup> See Stuart C. Gilson “Bankruptcy, Boards, Banks, and Blockholders”, 27 Journal of Financial Economics 355, 356 (1990) (“...models of bankruptcy often assume that creditors take control of the bankrupt firm’s assets”); Philippe Aghion & Patrick Bolton “An Incomplete Contracts Approach to Financial Contracting”, 59 Review of Economic Studies 473 (1992).

APPENDIX  
LIST OF CASES

- A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minnesota Supreme Court, 1981)
- Adams v. Erwin Weller Co.*, 87 F.3d 269 (8<sup>th</sup> Circuit, 1996)
- Admiral Oriental Line v. United States*, 86 F.2d 201 (Second Circuit, 1936)
- Aronson v. Lewis*, 473 A.2d 805 (1984)
- Baltimore & O. Tel. Co. of Baltimore County et al. v. Interstate Tel. Co.*, 54 Fed. 50 (4<sup>th</sup> Circuit, 1893)
- Benton Johnson v First National Bank of Shreveport*, 792 So. 2d 33 (La. App. 3 Circuit, 2001)
- Buck v Nash-Finch Company*, 78 S.D. 334; 102 N.W.2d 84 (Supreme Court of South Dakota, 1960)
- Chemtool, Inc. v. Lubricant Technologies Inc.*, 148 F.3d 742 (7<sup>th</sup> Circuit, 1998)
- Citibank, N.A. v. Data Lease Financial Corporation*, 828 F.2d 686 (11<sup>th</sup> Circuit, 1987)
- Coppola v. Bear Stearns & Co., Inc.* 499 F.3d 144 (2<sup>nd</sup> Circuit, 2007)
- Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919)
- Greylock Glen Corporation v. Community Savings Bank*, 656 F.2d 1 (1<sup>st</sup> Circuit, 1981)
- Henry v. Lehman Commercial Paper*, 471 F.3d 977 (9<sup>th</sup> Circuit, 2006)
- [\*In re Ames Dept. Stores, Inc.\*, 115 B.R. 34, \(Bankr. S.D. N.Y. 1990\)](#)
- In re Bush Terminal Co.*, 78 F.2d 662 (2<sup>nd</sup> Circuit, 1935)
- In re Glover, Inc.*, 43 B.R. 322 (Bkrtcy.N.M., 1984)
- In re Johns-Manville Corporation et al. v. The Equity Security Holders Committee*, 801 F.2d 60 (2<sup>nd</sup> Circuit, 1986)
- In re Iridium Operating LLC*, 478 F.3d 452 (2<sup>nd</sup> Circuit, 2007)



*In Re The Lionel Corporation v. The Lionel Corporation*, 722 F.2d 1063 (2<sup>nd</sup> Circuit, 1983)

*In re Ludwig Honold Manufacturing Company, Inc.*, 46 B.R. 125 (Bkrtcy.D.Ea.Penn., 1985)

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[\*In re Tenney Village Co., Inc.\*, 104 B.R. 562 \(Bankr. D. N.H. 1989\)](#)

*In the Matter of Clark Pipe and Supply Co., Inc. v. Associates Commercial Corporation*, 893 F.2d 693 (5<sup>th</sup> Circuit, 1990)

*In The Matter of Mobile Steel Company*, 563 F.2d 692 (3<sup>rd</sup> Circuit, 1977)

*In The Matter of Virtual Network Services Corporation*, 902 F.2d 1246 (7<sup>th</sup> Circuit, 1990)

*Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7<sup>th</sup> circuit, 1990)

*Mike Smith v. Ajax Magnathermic Corp., et. al*, 144 Fed. Appx. 482 (6<sup>th</sup> Circuit, 2005)

[\*National Westminster bank plc v Spectrum Plus Ltd\*](#), UKHL 41 (2005)

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